

**ROMANIA**

**WINNERS AND LOSERS:  
THE IMPACT OF REFORM  
OF INTERGOVERNMENTAL  
TRANSFERS**

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## EXECUTIVE SUMMARY

### *Purpose*

This analysis has two main purposes: (1) to identify the separate and combined impact of several changes in the intergovernmental fiscal system in 1999; (2) to recommend how the system (LLPF) can be modified to ameliorate adverse effects while strengthening fiscal autonomy and ensuring adequate basic service provision by all local governments.

### *What Happened in 1999?*

Article 8(3) of the Law on Local Public Finance brings important changes in the structure of local budgets. Earmarked subsidies and transfers have been replaced by revenue sharing of a national tax with the revenues allotted directly to local budgets. The only earmarked transfers remaining are those for investments financed through external loans. According to nationwide data provided by the Ministry of Finance, the wage tax is 52 percent of county council and 35 percent of local council budget revenues for 1999. Together with an increase in own revenues, this goes far to ensure the financial autonomy of local governments.

One of the main strengths of the new system is that it practically eliminates earmarked transfers, which gives greater discretion to local governments in spending decisions. The intergovernmental fiscal system also has been improved in terms of both predictability and transparency. Local governments know roughly how many revenues from the wage tax they will receive and are not dependent on any other level of government to distribute these revenue shares because they go directly to the local budget. With these new powers, local governments are expected to be more responsible for budget execution and investment planning.

In 1999, aggregate transfers (including revenue sharing of the wage tax, equalization grants and other subsidies) decreased in real terms by one third.<sup>1</sup> At the same time, aggregate own revenues increased in real terms by more than 100 percent. Comparing the recent (since 1997) *net* reduction in the expenditure side of the budget (health cuts minus future obligations on financing schools construction) with the *net* increases on the revenue side of the budget (tax increases minus overall cuts on fiscal transfers) one may conclude that on balance local governments at least in the aggregate do not appear to be worse off neither with respect to themselves, or the central government, than what they were in 1998. From this perspective, it is difficult to

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<sup>1</sup> Throughout this report we use the word transfer to indicate a broad category of equalization grants, subsidies and revenue sharing, mostly for lingual convenience. Another reason is that the drop in these collective revenues indicates how much more own revenues (in particular, local taxes and fees) individual and aggregate local governments must generate to maintain status quo. However, revenue shares from the wage tax are very different from other transfers because they are deposited directly in the accounts of the local and county councils as soon as the Ministry of Finance receives payment from the taxpayers. In this sense, revenue shares are almost own revenues.

argue that the *vertical* balance has shifted in favor of the central government and against the local governments.

However, it has been argued, that although these are the results for the aggregate of all local councils, the situation across local councils varies substantially. Because the share of local government budgets coming from own revenues went from 25 percent to 51 percent,<sup>2</sup> local governments with less capacity for generating own revenues were likely to perform poorly in 1999. Also in 1999, revenue shares became the most important transfer by far (84 percent), while transfers based on a formula developed by the Ministry of Finance became only a small portion (11 percent). As the wage tax is distributed according to origin of the tax collection, a local council would receive a smaller portion if:

- It has a relatively small number of wage taxpayers relative to the population either because of demographics or a high unemployment rate.
- It has a lower tax base because of lower wages or fewer businesses located in the jurisdiction. The latter could be a result of a low level of economic development or perhaps because its residents work at businesses located in neighboring jurisdictions.
- It has poor tax collections because of poor tax administration.

In order to analyze how changes in the rules for intergovernmental transfers affected the horizontal balance among local councils, we collected data from all of the territorial-administrative units located within five counties. The counties were selected based on their geographical size and economic strength, so as to represent variation in the country. As a note of caution, we emphasize that the sample may not be representative of the country as a whole, but represent more extreme situations than is typical. The sample includes about 11 percent of all local councils and about 11 percent of the total population. It contains approximately 57 percent urban population (44 percent living in municipalities and 13 percent in towns), and 43 percent rural population (living in communes), which is typical of the country as a whole.

Our analysis of the sample data shows that at the county level, at least, the amount of transfers received in 1998 were closely aligned with the population of the county. In 1999, transfers have been reduced for rural counties and increased for urban counties. We cannot judge if the distribution of transfers in 1998 was fair or if a particular local council received adequate transfers. We can conclude, however, that a serious drop in transfers would make everyday operations—not to mention investment planning—very difficult for a local council. Seventy percent of the communes and 56

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<sup>2</sup> According to nationwide data provided by the Ministry of Finance, the estimated share in 1999 was 42 percent for county councils and 56 percent for local councils.



percent of towns and municipalities in the sample received less than half as much in 1999 total transfers than in 1998 in real terms. The decrease in aggregate transfers combined with a redistribution of the transfer pool likely surprised many local councils with a very large drop in transfers.

Our analysis of the sample data further shows that local councils with poor own revenue generation also experienced a large decrease in transfers—making them clear losers under the Law. As a result, relatively poor rural areas appear to be more regionally concentrated. Local councils with strong own revenue generation were also more likely to have a large increase in transfers—making them clear winners from the changes brought about by the Law on Local Public Finance. In this sense, revenue sharing does not compensate for local fiscal imbalances due to differences in economic bases, but rather, reinforces such differences. We cannot blame the growing inequity on the transfer system since we know that the gap in own revenues widened greatly between 1998 and 1999. *However, the transfer system should attempt to increase equity by compensating for the growing gap in own revenues.*

According to Article 10(1) of the Law of Local Public Finance, the purpose of the equalization grant system is to achieve “budgetary balance.” However, in our sample data 35 percent of local councils had total revenues in 1999 that were less than half their 1998 level in real terms. Moreover, 13 percent of communes and 26 percent of towns and municipalities had 1999 per capita total revenues that were less than half the median value for its urban/rural type of local government. Considering that the median revenue level in Romania today is not very high, we can assume that local councils falling that much below the per capita median must have inadequate revenues. *The equalization grant system should focus on assisting these vulnerable local councils.*

## **Recommendations**

We have developed six recommendations to ameliorate adverse effects of the LLPF and to continue to support reform of Romania’s intergovernmental fiscal system. The recommendations are based on analysis of the Romanian system, including simulations of alternative policies, as well as lessons from other transitional countries.

- *Recommendation #1: Make the revenue sharing system more equitable.*
- *Recommendation #2: Improve targeting of equalization grants.*
- *Recommendation #3: Make the revenue shares and equalization grant funds predictable by setting the wage tax share to county councils and local councils and stabilizing the pool of funds for equalization grants through an amendment to the Law on Local Public Finance.*

- *Recommendation #4: Introduce enforcement methods for ensuring that county councils distribute equalization grants according to published criteria.*
- *Recommendation #5: Create a regional assistance program to address the causes of poor fiscal capacity.*
- *Recommendation #6: Delineate between national, county and local services and tie payments to benefits received.*

## **Conclusions**

Changes in the intergovernmental fiscal system introduced by the Law on Local Public Finance greatly improve the transparency and economic efficiency in the intergovernmental fiscal system. By enabling local governments to create budgets for which they are accountable, to plan long-term investments based on projected revenue flow, and to distribute revenues according to local priorities, the 1999 system strengthens local fiscal autonomy. The central government's role in the intergovernmental fiscal system is (1) to maintain macroeconomic stability, (2) to establish a predictable revenue base, comprised of own revenues and revenue shares, that is adequate for most local governments, and (3) to provide additional support to vulnerable local governments. In implementing the handful of recommendations described above, the central government will improve the equity and predictability of the system and further strengthen local fiscal autonomy.



## **PART I**

### **BACKGROUND**

#### **CHAPTER 1**

#### **MACROECONOMIC DEVELOPMENTS**

##### **1.1 *An Overall View***

The Romanian economy is in its third year of decline. This year, the decline of GDP is expected to be around 3.5 percent. The policy turnaround of 1997 involved both a major reduction in subsidies and making them transparent; the latter result was achieved by relieving monetary policy of its quasi-fiscal operations and the unification of the exchange rates. The magnitude of fiscal adjustment in 1997 and 1998 should be judged against the background of a substantial decline of the economy. This decline reduced the tax base and, presumably, increased the propensity for tax-evasion. The fact that the size of the consolidated budget deficit remained close to 4 percent, under circumstances when the public debt service has been on the rise, is a further indication of the magnitude of fiscal adjustment. This is why a better indicator of the adjustment is to look at the primary surplus (deficit). For 1999 an additional sign is the inclusion of a much lower figure for privatization revenues (only 1 percent).

An essential characteristic of the Romanian budget is the low tax collection. It suffices to compare the level of fiscal and non-fiscal revenues, as a share of GDP, in Romania as against other transition economies (Table II-4 in Annex II) to reach a conclusion: the functioning of institutions bears on the size of budget revenues as well. Taxes are not necessarily higher in Romania than in countries that collect much better; fiscal revenues in Hungary, Poland, and the Czech Republic are in the vicinity of the western average. This should give food for thought to Romanian authorities.

The low fiscal and non-fiscal revenues, in conjunction with the need to have a low budget deficit, forced policy-makers to drastically cut expenditures either when constructing the budget, or via rectification. The cut of expenditure affected negatively public investment and material expenses, reduced the room of maneuver for supporting education and health-care. In the last few years the budget of public education did not exceed 4 percent of GDP<sup>3</sup>; and the budget for health-care went below 3 percent of GDP. These two figures show how strained the state budget is. The strained budget explains also the reluctance of policy-makers to provide more resources to the discretion of local authorities.

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<sup>3</sup> This number includes the local resources mustered by local authorities.

## **1.2 The Execution of the Budget and Local Governments**

As already mentioned the execution of the budget meant, constantly, a retrenchment of expenditure at the time of rectification; a declining tax base, an extensive rate of tax evasion, sky-rocketing interest payments of the debt service, the inability to source foreign capital markets (after the Russian financial meltdown), and the need to cut the budget deficit in order to reduce the trade imbalance: all these factors forced policy-makers to combine a rise in taxes with a severe cut in expenditure.

The cut in expenditures explains also the inclination of policy-makers to provide less transfers to local public administration. The data speak for themselves. Thus, against the background of a steadily declining GDP the share of local government expenditure in GDP went down from 4.7 percent in 1996 (when it reached a peak) to 4.2 percent in 1997, and 4 percent in 1998; for this year the share is programmed to stay at 4 percent. Over the same period of time the transfers to the LPA, as a share of the state budget expenditure, went down from 16.1 percent (also a peak year) to 15.9 percent in 1997, and 12.9 percent in 1998; for this year the programmed transfers are even less, namely 10 percent of the state budget expenditure.

Clearly, the reduction of aggregate transfers to local public administrations strained the local budgets and prolonged the agony of numerous unfinished projects. Moreover, this dynamic did not help alleviate the plight of the poorest counties and of many communes which are discriminated against by the way the local government decision-makers allocate the funds between the urban and the rural areas. One has to bear in mind that around 45 percent of the population lives in rural areas and that wages are a main parameter in transfers. Therefore, an undifferentiated policy can accentuate discrepancies and social inequity. It is relevant, in this respect, that the last few years witnessed a rise of the share of transfers which went to municipalities and towns—to the detriment of the communes.



## CHAPTER 2 REVENUES, EXPENDITURES AND LOCAL FISCAL AUTONOMY IN ROMANIA

### 2.1 *The Law on Local Public Finance*

Article 8(3) of the Law on Local Public Finance brings important changes in the structure of local budgets. A large decrease in earmarked transfers from the Ministry of Finance gives greater discretion to local governments in spending decisions. The only earmarked transfers remaining are those for investments financed through external loans. Earmarked subsidies and transfers have been replaced by revenue sharing of a national tax with the revenues allotted directly to local budgets. The share from the wage tax represents a very important source for the local budgets that to a great extent ensures their financial autonomy.

In theory, the Law on Local Public Finance (LLPF) and the Annual State Budget Law (ASBL) define several methods for maintaining balance in local government revenues and expenditures:

- Assigning new revenue sources to local governments (e.g., privatization incomes)
- Transferring public services from the competency of local governments to the competency of other authorities (e.g., health care)
- Allowing local governments to assess piggyback taxes on some local and state taxes and duties—Article 8(5) of the Law on Local Public Finance
- Applying a system for sharing revenues from a national tax—defined as the wage tax in Article 8 (3) of the Law on Local Public Finance

However, the first two methods are generally applied in an inconsequent and confused manner. The third method is not yet available to local governments because the maximum limit for the piggyback taxes was not stipulated in the 1999 ASBL. Thus, revenue sharing of the wage tax is the most important aspect of the LLPF in terms of local government financial autonomy. The share distributed to each level of government was set in Article 8(3) of the LLPF, with 40 percent of the wage tax to the local council and 10 percent to the county council. However, the percentage share can be modified by the Annual State Budget Law. In 1999, the first year of application of the LLPF, the shares were modified as follows:

- 35 percent of the wage tax collected within a jurisdiction is retained as income to the respective local council; (collection is based on the location of the economic activity)
- 15 percent of the wage tax collected within a county is retained as revenues for the respective county council

## 2.2 Expenditure Responsibilities of Local Governments

The current (1999) assignment of functions for county councils and local councils are outlined in an annex of the Annual Budget Law as the expenditure side of the budget. While the two types of budgets are structured similarly, the specific tasks that they carry out are distinct. Local councils mainly provide those public services directly for that community's population, although some services may benefit residents of another community, such as students. The county councils, on the other hand, are responsible for services concerning a group of communities.

In Romania, the most important functions continue to be directly ensured by the state by means of the deconcentrated authorities (e.g., health, higher education, security, and public order). Other important functions are co-financed and managed in cooperation with the local authorities (e.g., pre-university education, housing and public services, and transport). A few functions (e.g., culture) are not co-financed by the state, but exclusively by local authorities.

A much discussed situation which also causes obvious discontent is that of the responsibilities delegated by the state without attaching adequate financing (ex. agriculture, social assistance in specialized institutions). These violate the principle that the taxpayers should be the same as the recipients of the public services.

Although the local public finance law does not present functions as "compulsory" or "voluntary", it defines certain local responsibilities in imperative terms such as "shall finance" "have to " (agriculture, education) and for other local public functions that appear as optional the term "can finance" (religion, sports).

In the period in which public services were provided free of charge by the central authorities their provision was according to the standards—minimal norms imposed by the state. Since the decentralization of public services provision some differences within a jurisdiction have become visible, or, even more frequently, among the various jurisdictions. Thus, the jurisdictions that have relatively high resources or relatively low costs (needs) can provide more public services of better quality.

Table 2-1 presents the structure of executed expenditures for the sample data by type of jurisdiction for 1998. In the local budgets of county councils, municipalities and towns, the biggest share of expenditures is for services and public development, housing, environment and water, with an increase in 1999. In the local budgets of communes (villages), the main share of expenditures is for public administration and, specifically for personnel.

**Table 2-1**



**Expenditure Structure by Type of Political-Administrative Jurisdiction (Percent share of actual 1998 expenditures)**

	County Councils	Municipalities	Towns	Communes
Local Administration	9.52	9.10	21.51	37.16
Education		16.21	16.41	12.58
Health		1.28	0.11	
Culture, Religion, Sports and Youth	6.12	1.31	4.66	5.60
Social Assistance	23.66	7.52	8.74	2.46
Public Services	32.44	51.54	46.02	27.10
Transport and Communications	26.76	11.66	1.70	11.06
Other Economic Activities	0.02		0.24	1.24
Other Activities	1.48	0.75	0.61	1.82
Interest Payments		0.02		0.03
Payment of Principal on Loans		0.61		0.96
<b>TOTAL EXPENDITURES</b>	100	100	100	100

Source: Based on administrative-territorial units in five counties.

## 2.3 Revenue Sources of Local Governments

### 2.3.1 Local Government Revenues Transferred from the State Budget

The local budgets benefit from financial transfers that can be classified as:

- Revenue sharing of national taxes;
- Transfers for investments financed through external loans guaranteed by the state;
- Equalization grants<sup>4</sup>

In 1999, the wage tax was the source for both revenue sharing and equalization grants. The Law on Local Public Finance establishes the categories and sets the shares of the wage tax to the national budget, the local councils and the county councils. The Annual State Budget Law (ASBL) can modify the shares of the national taxes transferred to county and local councils and it determines the pool of funds for both the investment transfers and the equalization grants.

According to nationwide data provided by the Ministry of Finance, the wage tax is 52 percent of county council and 35 percent of local council budget revenues. As the

<sup>4</sup> The LLPF also refers to piggyback taxes on national taxes, with the specific tax and maximum limit to be set by the ASBL. To date, this provision has not been implemented in practice.

wage tax is distributed according to origin of the tax collection, the revenue shares received by a jurisdiction is determined by:

- The number of wage tax payers in the jurisdiction (which is affected by demographics and the unemployment rate)
- The tax base in the jurisdiction (level of economic development)
- The level of actual collections (as opposed to taxes assessed)

### 2.3.2 Own Revenues

According to the Law on Local Public Finance and the budget classification of the Ministry of Finance own revenues include:

- Current fiscal and non-fiscal revenues
- Capital revenues
- Revenues with special destination

**Table 2-2**  
**Revenue Structure by Type of Political-Administrative Jurisdiction (percent share of actual 1998 revenues)**

	County Council	Municipality	Towns	Communes
<b>Local government revenues transferred from state budget</b>				
Sume defalcate (need grants / general subsidies)	36.07	33.35	46.62	43.81
Subventions (investment and other earmarked subsidies)	51.46	25.12	30.32	20.93
<b>Own revenues</b>				
Capital revenues	0.01	0.43	0.82	0.23
<i>Non-fiscal revenues</i>	<i>1.16</i>	<i>16.9</i>	<i>5.64</i>	<i>12.41</i>
Transfers from the net profit of utilities	0.21	2.29	0.5	1.79
Transfers from public institutions	0.45	9.33	1.36	4.87
<i>Local taxes and fees</i>	<i>11.08</i>	<i>23.47</i>	<i>15.79</i>	<i>20.74</i>
Profit tax	7.83	1.3	0.21	0.23
Fees for use of state property		1.45	0.98	0.94
Land and building tax (juridical persons)		7.74	7.21	6.02
Vehicle tax (juridical persons)			0.01	0.18



**Table 2-2 (Continued)**

	County Council	Municipality	Towns	Communes
<i>Taxes and fees from the population</i>		0.69	0.83	1.91
Tax on income for self-employed		1.32	1.88	3.28
Land and building tax (physical persons)		1.28	0.87	2.08
Vehicle tax (physical persons)		0.8	0.56	1.25
Tax on income of physical persons not employed		5.02	2.15	1.63
Other direct taxes	0.58	2.04	0.25	2.38
Indirect taxes	2.67	1.84	0.83	0.84
<b>Loans Received</b>	<b>0.21</b>	<b>0.73</b>	<b>0.81</b>	<b>1.88</b>
<b>TOTAL REVENUES</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Based on sample of administrative-territorial units in five counties.

The current fiscal revenues have undergone various modifications since the Law on Local Taxes and Fees was passed in 1994, and amended in 1997 and 1998. Fiscal revenues have increased both in amount and in the share of the local budgets. In towns, the share of the budget coming from fiscal revenues was 3.2 times greater in 1999 than in 1998. In county councils, the share increase was 1.15 times (Table 2-2). In the current year, fiscal revenues represent the main sources of local revenues for the budgets of municipalities, towns and villages. Only in county councils are the fiscal revenues not the main source of local revenues.

Revenues with special destination are a new budget category introduced in 1999, and are the special taxes which had been previously defined in the Law on Local Taxes and Fees. These are special fees to secure the operation of local or county public services. The special fees are collected exclusively from physical and legal persons benefiting from the local services for which the respective fee was established and are used exclusively for the investment and operating expenses of these services.

### 2.3.3 Criteria for Fiscal Autonomy

The degree of financial autonomy enjoyed by local governments depends on their authority to:

- Create (levy) new local taxes and fees
- Determine the tax base
- Establish the tax rates for local taxes
- Ensure tax collection

— Obtain revenues directly

# **The competence to create new revenue sources.** In Romania, the Annual State Budget Law lists the possibility of local revenues (see Table 2-3). The local authorities have competence only for establishing “revenues with special destination,” described above.

# **The competence to establish the tax base.** The local authorities cannot decide on the base of their local taxes, nor on whom taxes will be levied, except to grant tax exemptions, delays and spacing out of tax payments.

# **The competence to establish tax rates.** The Law on Local Taxes and Fees establishes maximum tax rates on some types of tax and a range of rates for many fees. The local council can increase or decrease the proposed tax and fee rates within a range of 50 percent. Many local taxes are not assessed based on the market value of the taxable item, but on the basis of a fixed value. Therefore, the tax revenue does not automatically adjust with inflation. In these circumstances, the local council can apply an inflation index correction, but only if inflation exceeds 20 percent.

# **The competence to collect the local revenues.** The 1997 changes to the Law on Local Taxes and Fees stipulated that starting January 1, 1999 local governments must create special bodies and departments for collection of local taxes (formerly the responsibility of the Ministry of Finance’s local departments). At the end of 1998, the deadline was delayed until January 1, 2000. In certain cases this competence looks more like a constraint than a factor of autonomy.

**Table 2-3**  
**Current Assignment of Revenue Sources by Type of Political-Administrative Jurisdiction**

	All Local Councils	County Councils
<i>Capital revenues</i>	Yes	Yes
<i>Non-fiscal revenues</i>		
Transfers from the net profit of utilities	Yes	Yes
Transfers from public institutions	Yes	Yes
<i>Local taxes and fees</i>		
Profit tax	Yes	Yes
Fees for use of state property	Yes	
Land and building tax (juridical persons)	Yes	
Vehicle tax (juridical persons)	Yes	





**Table 2-3 (Continued)**

	<b>All Local Councils</b>	<b>County Councils</b>
Taxes and fees from the population	Yes	
Tax on income for self-employed	Yes	Yes
Land and building tax (physical persons)	Yes	
Vehicle tax (physical persons)	Yes	
Tax on income of physical persons not employed	Yes	
Other direct taxes	Yes	Yes
Indirect taxes	Yes	

# **The ability to obtain revenues directly without approval by the central or county government.** The Law on Local Public Finance considerably increased the revenues received in a direct form (from 20 percent in 1998 to 90 percent in 1999) which increases local autonomy in allocating these resources.

#### **2.3.4 Other (Loans)**

The most revolutionary provision of the Local Public Finance Law is the possibility for local authorities to obtain credit in their own name from the domestic and foreign capital market. The credit can be ordinary loans or issuance of municipal bonds. However, little progress in the banking and public property legislation has made it difficult for local governments to exercise this new authority.



## PART II

### ANALYSIS OF INTERGOVERNMENTAL FISCAL RELATIONS

#### CHAPTER 3 THE VERTICAL BALANCE

This chapter assesses the evolution of expenditure responsibilities of local governments in contrast to their revenue sources during the last three years (1997-1999). The main focus of the analysis is to identify any significant changes in the *vertical balance* between the expenditure functions of local governments and their revenue sources. Particular attention will be given to the most recent changes (1998-1999) due to the fiscal adjustments in compliance with macroeconomic stabilization policy.

Comparing the *net* reduction in the expenditure side of the budget (health cuts minus future obligations<sup>5</sup> on financing schools construction) with the *net* increases on the revenue side of the budget (tax increases minus overall cuts on fiscal transfers) one may conclude that on balance local governments at least in the aggregate do not appear to be worse off neither with respect to themselves, or the central government, than what they were in 1998. From this perspective, it is difficult to argue that the *vertical balance* has shifted in favor of the central government and against the local governments. The data analyzed, as it will be further examined below, seems to suggest rather the opposite conclusion.

However, it has been argued, that although these are the results for the aggregate of all LGs, the situation across LG, varies substantially. Some LGs are substantially better off while others are much worse off. The above is due to the fact that the most significant part of fiscal transfers depends on revenue sharing, which is based on the origin of the resources. This means that those LG with greater revenues get a greater proportion of transfers, while those with smaller revenues get proportionally less. In this sense, revenue sharing does not compensate for local fiscal imbalances due to differences in economic bases, but rather, reinforces such differences.

#### **3.1 Changes in Local Government Expenditure Responsibilities**

Two main changes in expenditure assignment occurred in 1999. Health expenditures on personnel were taken back by the central government from the local governments, and capital expenditures in schools were assigned as a function of the local governments.

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<sup>5</sup> The new expenditure obligations on education are not recurrent, but refer to capital outlays for school construction. This will require local governments to do some investment planning and use part of their new recurrent revenues to finance long-term capital investments in the construction of new schools.

For 1999 consolidated local government expenditures is estimated at about 19,168 billion lei. During the period analyzed (1997-1999), local government expenditures increased in nominal terms, but declined in real terms. Regarding the expenditure structure, in 1997, most of the expenditures (39%) concentrated on public services, such as power and water supply, transport (19%), education (10%), and health (12.6%). However, since 1998, most of the expenditures in health services were absorbed by the central government. This was reflected in a drop of 1,200 billion lei in local government expenditures in health from 1997 to 1999. In addition, the responsibility of capital expenditures in education (schools construction) was transferred back to the local governments. However, from 1997 to 1999, capital expenditures in education increased by a fairly small magnitude in 100 billion lei. For 1999, the new expenditure structure is as follows: Public services, such as power and water supply (38.4%), transport and communications (12.6%), education (9.3%), social programs (7.4%), and health (0.5%). The latter dropped by about 12 percent with respect to 1997 due to the reassignment of expenditures functions, as noted above.

**Table 3-1**  
**Expenditure Structure (in billions of 1999 lei)**

<b>Expenditures</b>	<b>1997</b>	<b>%</b>	<b>1998</b>	<b>%</b>	<b>1999</b>	<b>%</b>
Administration	822.2	7.9	1,796.7	13.4	2,946.1	15.4
Education	1,041.0	10.0	1,209.2	9.0	1,780.4	9.3
Health	1,325.0	12.8	68.8	0.5	102.7	0.5
Culture & Others	486.9	4.7	654.3	4.9	826.2	4.3
Social Assistance	479.5	4.6	1,243.8	9.3	1,418.0	7.4
Public Services	4,042.5	38.9	5,532.1	41.3	7,361.7	38.4
Agriculture	0.0	0.0	0.0	0.0	211.8	1.1
Transport & Comm.	2,034.5	19.6	2,711.9	20.3	2,415.6	12.6
Economic Activities	6.5	0.1	6.4	n.g.	13.4	0.1
Other Activities	91.5	0.9	135.9	1.0	188.2	1.0
Capital Outlays	40.7	0.4	22.3	0.2	80.2	0.4
Reserves	0.0	0.0	0.0	0.0	101.3	0.5
Especial Purpose	0.0	0.0	0.0	0.0	1,722.5	8.9
<i>Total</i>	<i>10,370.3</i>	<i>100.0</i>	<i>13,381.4</i>	<i>100.0</i>	<i>19,168.1</i>	<i>100.0</i>
Price Index in %(1999)	292.0		140.6		100.0	
<i>Total Real Terms</i>	<i>30,281.2</i>		<i>18,814.2</i>		<i>19,168.1</i>	

Source: Romanian Government, Department of Local Governments/MOF.



In balance, by the end of 1999, the net impact of the fiscal adjustments at the local level are expected to represent greater expenditure reductions (“savings”) rather than greater expenditure responsibilities. However, local governments need to plan the financing of future capital outlays in education, specifically the construction of new schools. In 1999, local governments are using part of their budgetary “savings” in social programs. The analysis of the *net* fiscal impact of the changes in expenditure functions and changes on the revenue side of the budget of local governments will be further examined below under the revenue structure section.

### **3.2 Changes in Local Government Revenues**

For 1999 consolidated revenues for all local governments, including counties, is estimated to be 19,168 billion lei. Local government revenues have been growing, both in nominal and real terms. The most recent executed budgetary data (1998) show that fiscal transfers together with subsidies from the central government are the most important revenue source of local governments. In 1998, they were equivalent to 74.7 percent of total local revenues. Based on revenue estimates of the Ministry of Finance, for 1999 the relative weight of fiscal transfers and subsidies together is expected to drastically drop to a level of 48.2 percent. This significant reduction is due to the cut in subsidies by the central government to local services, such as heating and transport. However, these subsidies (which are given to the producer of the service, rather than the people), apparently continue to be the responsibility of the local governments. In contrast, fiscal transfer (without including subsidies) have substantially increased in nominal and real terms from 1998 to 1999. The main reasons have been the creation of the fiscal equalization grant that has become effective in 1999, as well as the increase in the revenue sharing system on the national wage tax. Briefly, the reduction in the overall transfers from the central government to the local governments has been due to the drastic reduction in subsidies, of about 4.500 billion lei. However, taking into account the increases in revenue sharing and grants for fiscal equalization, the net drop in overall transfers is about 815 billion lei.

Overall fiscal transfers from the central to the local governments have decreased as a proportion of the Central Government budget from about 13.0 to 10.0 percent. As a proportion of the local budgets, including subsidies, they are estimated to drop from 1998 to 1999 in nominal and real terms. Adjusting by inflation, and based on 1999 prices, they are expected to fall from the equivalent of 10,145 billion lei (1998 real) to 9,237 billion lei in 1999—i.e., a drop of about 10 percent in real terms.



**Table 3-2**  
**Revenue Structure (in billions of 1999 lei)**

REVENUES	1997	%	1998	%	1999	%
Fiscal Transfers	4,644.5	44.4	4,997.9	37.1	8,798.1	45.9
Subsidies	3,790.2	36.2	5,054.4	37.6	439.4	18.7
Non-Tax Own Revenue	340.1	3.2	581.3	4.3	3,584.2	18.7
Local Taxes	1,502.2	14.3	2,476.5	18.4	6,347.1	33.1
Donations	0.1	n.g.	0.7	n.g.	0.0	0.0
Surplus	98.0	0.9	72.7	0.5	0.0	0.0
Other	93.3	0.9	270.6	2.0	0.0	
TOTAL	10,468.4	100.0	13,454.1	100.0	19,168.8	100.0
Price Index in % (1999)	292.0		140.6		100.0	
Total in Real Terms	30,567.7		18,916.5		19,168.8	

Source: Romanian Government, Department of Local Governments/MOF.

In nominal terms the budgeted reduction from 1998 to 1999 of total transfers (including subsidies) is about 815 billion lei. Comparing the revenue cuts in overall transfers with the “savings” on expenditures due to the 1998 cuts in health care of about 1,200 billion lei, it may be concluded (taking into account the effects of the last two years) that in balance the *net cash flow* for local governments is still positive for the consolidated of all local governments by about 385 billion lei.

The second main source of local revenues (18.4 percent) is given by local taxes. For 1999, however, local taxes are expected to increase substantially. It is estimated that they will be equivalent to about one third (33.1 percent) of total local revenues. The main increase in local taxes come from the adjustment of the tax bases and rates of the land and building taxes for both, juridical and physical persons. For 1999, additional revenues from local taxes are expected to continue their growth both in nominal and real terms. In 1998 total taxes were about 988.4 billion lei and for 1999 they are expected to reach the level of 4,062 billions lei. In *net* and in nominal terms local taxes are expected to add about 3,000 billion lei to the revenue side of the budget.

Annex III provides more detailed information on changes in local government revenues and expenditures.



## CHAPTER 4

### EVALUATION OF ROMANIA'S REVENUE SHARING SYSTEM

This chapter assesses Romania's revenue sharing system based on desirable features for a fiscal transfer system. It also describes shifts in the horizontal balance among local councils as a result of implementation of the Law on Local Public Finance (LLPF) and other policy changes in 1999.

There are several strengths and a few remaining problems with the new revenue sharing system. The first main strength is that the system reduces the amount of earmarked transfers, which gives greater discretion to local governments in spending decisions. The transfer system has been improved in terms of both predictability and transparency. Local governments know roughly how many revenues they will receive and are not dependent on any other level of government to distribute these revenues. With these new powers, local governments are expected to be more responsible for budget execution and investment planning.

We can identify two main problems with the revenue sharing system. The first problem concerns the remaining unpredictability in the system due to the fact that although the share distributed to each level of government was set in the LLPF, this share can be modified annually by the Annual State Budget Law. This problem seriously hampers the ability of local governments to prepare accurate budgets and make long-term investment plans.

The second problem concerns the inequality caused by the system. In order to analyze how changes in the rules for intergovernmental transfers affected the horizontal balance among local councils, we collected data from all of the territorial-administrative units located within five counties. The counties were selected based on their geographical size and economic strength, so as represent variation in the country. As a note of caution, we emphasize that the sample may not be representative of the country as a whole, but represent more extreme situations than is typical. The sample includes about 11 percent of all local councils and close to 11 percent of the total population. It contains approximately 57 percent urban population (44 percent living in municipalities and 13 percent in towns), and 43 percent rural population (living in communes), which is typical of the country as a whole. The sample's total transfers in 1999 (541 billion lei) are about 7 percent of all local council transfers in 1999 (7,261 billion lei).

Our analysis shows that at the county level, at least, the amount of transfers received in 1998 were closely aligned with the population of the county. In 1999, transfers have been reduced for rural counties and increased for urban counties. Relatively poor rural areas appear to be more regionally concentrated. We cannot judge if the distribution of transfers in 1998 were fair or whether a local council received adequate transfers. However, whether or not 1998 transfers were adequate, having

them cut in half would make everyday operations—not to mention investment planning—very difficult for a local council. Counting “losers”—local councils that received less than half as much in 1999 total transfers than in 1998 in real terms—is as much a measure of stability as it is of equity. In our sample, seventy percent of the communes and 56 percent of towns and municipalities were “losers.” The high number of losers is a result of the combined impact of the decrease in aggregate transfers and a redistribution of the transfer pool. Beyond this, disparity in total revenues per capita grew slightly for communes and dramatically for towns and municipalities. We cannot blame the growing inequity on the transfer system since we know that the gap in own revenues widened greatly between 1998 and 1999. *However, the transfer system should attempt to increase equity by compensating for the growing gap in own revenues.*

#### **4.1 Normative and Empirical Review of the System**

Based on ten desirable features for a fiscal transfer system, we can evaluate Romania’s revenue sharing system implemented in 1999.<sup>6</sup>

# **Predictable.** The introduction of the revenue sharing system has improved Romania’s fiscal transfer system in terms of predictability. The pool of resources (the wage tax) was pre-defined and the share to all local governments remained at 50 percent, although the distribution between local councils and county councils did change. The system could be more predictable if the shares could not be annually modified through the State Budget Law.

# **Transparent.** The revenue sharing system has increased transparency in Romania’s fiscal transfer system by introducing a clear and simple formula that is known to all local governments. Also, since the money is allocated directly to the local budgets and does not pass through the central budget, there is no danger of intermingling of funds that might change how much or how soon a local government may receive its revenues.

# **Non-discretionary budgetary allocation.** The new revenue sharing system has not eliminated the discretion in the budgetary allocation for fiscal transfers because the shares of the wage tax distributed to the State budget and to the budgets of local governments can be modified annually.

# **Adequate.** For the 35 percent of local councils in our sample that had total revenues in 1999 less than half their 1998 level, transfers were not adequate. This is

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<sup>6</sup> These features are further explained in Annex I, which also provides a conceptual and economic rationale for intergovernmental transfers.





despite the fact that increases in own revenues more than compensated for the decrease in transfers in the aggregate. Thus, the goal of achieving adequacy is inextricably linked with how revenues are distributed.

# **Equitable.** As mentioned above, 70 percent of communes and 56 percent of towns and municipalities in our sample were “losers” in 1999 because their transfers were more than cut in half in real terms compared to 1998. Inequity—as measured by the share of local councils with per capita total revenues less than half the median for similar local government types—increased in 1999, in particular for towns and municipalities. Although overall inequity among communes only slightly increased, the poorer communes appear to be more regionally concentrated in 1999 than in 1998.

# **Economically efficient.** The new revenue sharing system increases efficiency because it gives local governments more autonomy and flexibility in allocating revenues across local functions. The previous system earmarked most of the fiscal transfers. According to the principles of economic efficiency, the government closest to and most accountable to the beneficiaries of the public services (that is, local governments) can best decide how to allocate funds for those services.

# **Non-distorting of local tax effort.** The new revenue sharing system does not distort the local tax effort because the amount of revenues that it receives as revenue sharing of the wage tax does not depend on the level of its own revenues. The higher the total collections of the wage tax in a jurisdiction, the greater the revenues it will receive from the revenue sharing system.

# **Incentive for good financial management.** Article 5 of the LLPF increases the decision-making role and the responsibilities of local authorities to prepare, approve and adjust the budget. Having received greater predictability in their fiscal transfers and greater flexibility in allocating revenues, local governments have more responsibility to budget accurately and in line with the priorities of their community. The new system, thus, encourages reporting outputs and increasing cost efficiency, as the local governments are more accountable for their budget results.

# **Buoyant to the economic growth rate.** By tying the fiscal transfers to a broad-based national tax, it was hoped that fiscal transfers would be buoyant to the economic growth rate. However, wage tax collections have not kept up with GDP growth. In fact, wage tax collections as a share of GDP have decreased every year from 6.5 percent in 1994 to 4.8 percent (estimated) in 1999. These figures are not surprising for an economy in transition. During the transition period the established economy of large firms decreases. Both the “gray” (economic activity that is legal but not reported) and the “black” (illegal economic activity) economy increase, as well as the income from self-employed entrepreneurs that do not pay wage tax.

The good news is that the Ministry of Finance predicts that collections for the global income tax will exceed those of the wage tax. However, the Ministry of Finance must keep in mind the local governments now receive 100 percent of the income tax on self-employed entrepreneurs and of non-employed residents. According to our sample of five counties, these two taxes together were approximately 5 percent of commune revenues and over 6 percent of municipality revenues in 1998—a small, but significant amount. In determining the correct share of the global income tax to be distributed to local councils, the Ministry of Finance should bear in mind that local councils will be losing a portion of these revenue sources.<sup>7</sup>

# **Insulated from partisan politics.** Except for the possibility of modifying the shares of the wage tax, the new revenue sharing system is generally insulated from partisan politics. Jurisdictions are neither hurt nor rewarded by the political affiliation or political actions of their leadership.

#### 4.2 *What Happened in 1999?*

# **Own revenues.** From 1998 to 1999, own revenues of local councils more than doubled in real terms. Own revenues also increased as a share of all revenues—from 20 percent to 61 percent of local budgets.

Variation in the ability to increase own revenues appears to be stronger among regions than among urban/rural type of local government. In one county, only 6 percent of the communes and none of the towns and municipalities were able to double their own revenues in real terms. In another county, 92 percent of the communes and all of the towns and municipalities doubled their own revenues. It is interesting that these two counties representing the extremes are also the most rural counties in the sample. Thus, although fiscal capacity does vary considerably from region to region, one cannot assume that a local council in a more rural county will have poorer fiscal capacity than a similar type local council in a more urban county.

Although many communes were able to increase own revenues, they still have a smaller tax base, so their own revenues are generally far below the own revenues of towns and municipalities, even on a per capita basis. The median own revenues for local councils in the sample was 120,000 lei per capita for communes and 277,000 lei per capita for towns and municipalities. There is also regional variation in median per capita own revenues. It is not surprising that the county with the highest median per capita own revenues for communes was also the county in which almost all of the communes doubled their own revenues. Likewise, the county with the lowest median

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<sup>7</sup> The loss will be equal to 100 percent minus the share of the GIT allotted to local councils.



per capita own revenues for communes was also the county in which only 6 percent of communes doubled their own revenues. In only one county are median per capita revenues for communes higher than those of towns and municipalities.

# **Central transfers.** Central transfers decreased by almost 30 percent in real terms. Small municipalities and communes of all population categories suffered great losses in transfers while larger towns and municipalities suffered little or no loss in transfers.

Variation in transfers received show a very strong urban and rural divide. In 1998, a county's share of total transfers closely correlated with its share of total population. In 1999, the transfer share to more rural counties was cut in half, while the transfer share to the most urban county nearly doubled (Table 4-1).

**Table 4-1**  
**Comparison of Share of Total Transfers, 1998 to 1999 by County**

By County	Percent of county population that is urban	Percent population of the sample	1998 Share of total transfers in the sample (%)	1999 Share of total transfers in the sample (%)
Total	100	100	100	100
County 1	8	12	14	7
County 2	43	32	35	61
County 3	20	16	19	5
County 4	17	26	23	21
County 5	12	13	10	5

Both the sample and nationwide data provided by the Budget Department of the Romanian Ministry of Finance show that municipalities increased their share of the transfer pool and communes saw a decrease in their share. The nationwide data indicate that the share to towns decreased, while data in our sample indicate that the share increased.

In 1999, the median per capita transfers received by towns and municipalities in the sample (209,000 lei per capita) was nearly three times the level received by communes in the sample (72,000 lei per capita). For communes there is much less variation among counties in transfers received than there is in own revenues generated. For towns and municipalities, the variation among counties in transfers received and in own revenues is about the same.

# **Total revenues.** Because own revenues vary strongly by region and transfers vary strongly by urban/rural type of local government, total revenues vary both by county and by type. Median total revenues are 207,000 lei per capita for communes and 490,000 lei per capita for towns and municipalities. The median per capita revenues for communes in the poorest county are less than half the level for the richest county.

Annex IV contains more detailed information on changes in the horizontal balance.



## CHAPTER 5

### EVALUATION OF ROMANIA'S EQUALIZATION GRANT SYSTEM

This chapter describes the current system of equalization grants and how it differs from its predecessor—some defalcate, or general subsidies. It also assesses the equalization grant system according to ten desirable features of a fiscal transfer system.

According to Article 10(1) of the Law of Local Public Finance, the purpose of the equalization grant system is to achieve “budgetary balance.” However, 35 percent of local councils had total revenues in 1999 that were less than half their 1998 level in real terms. Moreover, 13 percent of communes and 26 percent of towns and municipalities had 1999 per capita total revenues that were less than half the median value for its urban/rural type of local government. Considering that the median revenue level in Romania today is not very high, we can assume that local councils falling that much below the per capita median must have inadequate revenues. These figures suggest that the equalization grant system has not achieved its purpose.

The three main weaknesses preventing the equalization grant system from achieving its purpose are: (1) the unpredictability of the pool of funds to be used for equalization grants; (2) the formula, which does not target funds to local councils that have inadequate revenues to provide basic services; and, (3) the lack of accountability at the county level for distributing funds according to published criteria.

The equalization grant formula used in 1999 introduces a fiscal capacity criterion, but the larger weight (70 percent) still goes to proxies for operating costs. The result is that local councils benefiting the most from revenue sharing were as likely to receive a large equalization grant as local councils benefiting the least from revenue sharing. By distributing equalization grants regardless of need, the equalization grant system did not achieve its purpose of increasing equity.

The lack of accountability at the county level stems from the fact that the Law on Local Public Finance did not establish objective, clear and workable criteria for allocating the equalization grants. One appropriate solution is for the Ministry of Finance to set guidelines (for example, at least 60 percent of the weight must be for fiscal capacity), but to leave some discretion at the county level.<sup>8</sup> However, it is most important that county councils responsibly use this discretion and follow correct procedures in developing the criteria.

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<sup>8</sup> In 1999, the Ministry of Finance specified the maximum amount in lei to be retained by each of the 41 county councils and the corresponding minimum amount to be distributed. These instructions were published in Appendix 5 of the 1999 Annual State Budget Law.

## 5.1 Description of the Current System

Although the Law on Local Public Finance (LLPF) introduces equalization grants, their budget classification, *sume defalcate* (literally “shared amounts”) has existed for several years. *Sume defalcate* were transfers in the form of general subsidies, as opposed to other subventions (*subventii*) which were mostly earmarked for either specific investment projects or the subsidy of heat or public transit (known as “social” subsidies). Each year, the Annual State Budget Law publishes the pool of funds for *sume defalcate* and the criteria and corresponding weights for distribution. Prior to 1999, these criteria were proxies for operating expenditures of a local government. The equalization grants distributed in 1999 followed similar criteria except for the addition of an indicator for fiscal capacity. The criteria are applied at the county level and county councils are responsible for distributing *sume defalcate* among the local councils within their county.

**Table 5-1**  
**Criteria for Distribution of *Sume Defalcate* in 1997, 1998, and 1999**

	1997	1998	1999
Population	12	8.5	5
Length of city streets	4	8.2	5
Length of roads	2	15	5
Number of housing units	2	5	5
Length of water and sewerage network	3	10	8
Number of pre-university students	34	45	25
Number of children in orphanages	—	3.3	15
Number of territorial-administrative units	3	5	2
Fiscal capacity	—	—	30
Number of hospital beds	34	—	—
Number of exemptions	6	—	—
Total	100	100	100

Before 1999, the portion of the *sume defalcate* retained by the county council for their own budgets was unspecified. Article 10(3) of the LLPF specifies that county councils may retain only up to 25 percent of these funds for their own budget. The remaining 75 percent (or more) of these funds must be distributed among the local councils located in each county.

In the 1997 and 1998 ASBL, county councils were directed to take into consideration the published criteria and the specific economic, social and demographic



conditions of each jurisdiction in distributing the *sume defalcate*. The LLPF attempts to formalize this process by making county councils responsible for developing a set of criteria and creating an allocation formula, in consultation with the local councils and with the technical assistance from the DGFPS (General Division of Public Finance and for State Finance Control, Ministry of Finance). One frequent criticism of the LLPF is that it did not establish objective, clear and workable criteria for allocating the equalization grants.

With the changes brought about by the Law on Local Public Finance, the size of the *sume defalcate* was reduced significantly. Before 1999, the *sume defalcate* were roughly half of all local government revenues transferred from the State, while in 1999 they were only 11 percent of these transfers. In nominal terms the *sume defalcate* decreased from almost 5 trillion lei in 1998 to only 1 trillion lei in 1999.

The role of the *sume defalcate* has also changed. Article 10(1) of the LLPF states that:

*"In order to create a budgetary balance among certain territorial-administrative units, the budget law can provide for the amounts of the shared funds from certain revenues of the state budget (sume defalcate) as well as for distribution criteria of the latter to territorial administrative units."*

The words, "budgetary balance," suggest that the *sume defalcate* criteria should attempt to equalize along revenues in addition to taking into consideration variations of expenditure needs. This is especially important because many of the local governments that receive the least per capita revenues from the new revenue sharing system are the same ones that generate the least per capita own revenues.<sup>9</sup>

## **5.2 Normative and Empirical Evaluation of the System**

To evaluate the effectiveness of Romania's equalization grant system, we draw upon the same sample budget data from local councils in five counties and the same desirable ten criteria for a fiscal transfer system described in the previous chapter.

**1. Predictable.** The equalization grants were not predictable because local governments could not predict how much money would be distributed in total and could not predict how much money would be allocated to each jurisdiction. Although, the Ministry of Finance did follow criteria published in the Annual State Budget Law for

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<sup>9</sup> There is a clear correlation in the sample between low per capita own revenues and low per capita revenues from revenue sharing of the wage tax. Most of the towns (86 percent), municipalities (67 percent), and communes (63 percent) having the lowest third per capita own revenues also had the lowest third per capita revenues from revenue sharing of the wage tax.

allocating equalization grants among counties, these criteria can be changed each year in the state budget. In fact, each year the state budget may or may not include any funds for equalization grants.

**2. Transparent.** The Ministry of Finance published the criteria used for allocating the equalization grants among counties. Added to these criteria was an adjustment factor that reduces the transparency of the system. Transparency of the distribution system at the county level depended on each county council. Some county councils created and published criteria for distributing the equalization grants. Other county councils did not appear to follow any stated criteria in distributing the money.

**3. Non-discretionary budgetary allocation.** The pool of funds to be used for equalization grants appears to be completely discretionary. The Law on Local Public Finance states that the state budget *can* allocate revenues for equalization grants and gives no guidance on how much revenues will be devoted for this purpose.

**4. Adequate.** Given the current revenue sharing system and the limited ability of many local governments to generate own revenues, the funds distributed as equalization grants were not adequate for attaining the “budgetary balance” that is described as the purpose in Article 10(1) of the LLPF. Thirty-five percent of all local councils had 1999 total revenues less than half their 1998 level.

As mentioned in the previous chapter, the revenue fall for these local councils was a result of two factors: sharp decreases in transfers and weaker than average ability to generate own revenues. In some cases, local councils were doubly hit because their transfers decreased and they were not able to take advantage of new legislation that would increase their own revenues. As part of increasing local autonomy, own revenues will play an increasingly greater role in local budgets. The Ministry of Finance should be very concerned about these jurisdictions, and should identify the stumbling blocks to increasing own revenues. If the stumbling blocks are external factors, such as regional downturn in the economy, then it would be appropriate to address these through regional assistance programs.

**5. Equitable.** Although the role of the *sume defalcate* has changed, the county councils are still distributing *sume defalcate* (equalization grants) to most local councils, instead of targeting local councils with the greatest need.

The 70 percent weight for the criteria which serve as expenditure proxies overwhelms the 30 percent weight of the indicator for fiscal capacity. The result is that local councils benefiting the least from revenue sharing did not receive a much larger share of the equalization grants than the local councils benefiting the most from revenue sharing. (See Annex V for more detailed analysis.)





**6. Economically efficient.** The equalization grant criteria for 1999 were not economically efficient because they included the length of the water and sewerage network. The costs of providing water and sewerage services should be paid for by tariffs, not by general taxes. The level of services should be directly related to the ability and willingness of the beneficiaries to pay for the service and should not depend on the local budget. It is not the role of the central government, thus, to equalize based on this criterion.

**7. Non-distorting of local tax effort.** The equalization grant system may have a small distorting effect on the local tax effort. Fiscal capacity is included among the criteria established by the Ministry of Finance. According to the formula, counties with weaker fiscal capacity (as indicated by own revenues and revenues from the wage tax) are compensated with greater equalization grants. Theoretically, a jurisdiction might reduce its efforts in collecting own revenues so that it will receive more in equalization grants. However, this is not logical because the jurisdiction will be worse off as it will lose more in own revenues than it will gain in equalization grants.

We should note that it is practically impossible to design an equalization grant system that will have no distorting effect on the local tax effort. The purpose of the equalization grants is to compensate for weak fiscal capacity. The best indicator for fiscal capacity is existing tax revenues. It is very difficult to create a proxy for fiscal capacity that is verifiable and cannot be changed or manipulated by the local governments receiving the equalization grants.

**8. Incentive for good financial management.** The equalization grant criteria have been neutral with regards to providing incentive for good financial management.

**9. Buoyant to the economic growth rate.** The equalization grants are not buoyant to the economic growth rate because they are not linked to a share of the state budget or of a national tax (or of a group of taxes). Therefore, they will not automatically grow with the economy's ability to provide more funds for equalization.

**10. Insulated from partisan politics.** At the national level, the equalization grant system is generally insulated from partisan politics because the distribution follows published criteria (with the exception of the adjustment factor). At the county level, the equalization grant system is not insulated from partisan politics. As mentioned above, Article 10(3) of the Law on Local Public Finance states that county councils should distribute equalization grants "after consultation with the mayors, and with the technical assistance of the DGFPs, on the basis of the approved distribution criteria."

However, the criteria published in the Annual State Budget Law used by the Ministry of Finance for allocating equalization grants among counties was not appropriate for use at below the county level. For example, the criterion "number of

administrative-territorial units” does not have any meaning below the county level. There are also criteria for both roads and city streets, while a jurisdiction below the county level has one or the other, not both. The criterion “number of children in orphanages” only makes sense if the local councils fund these from their own budget. Beyond this, other social expenditures are not accounted for in the formula.

Thus, in 1999 it is clear that county councils did not follow the criteria established by the Ministry of Finance for allocation of equalization grants among counties. Some county councils created new criteria that were debated and published. Other county councils appeared to have distributed the equalization grants without public debate, nor published criteria.

## PART III

### POLICY OPTIONS AND RECOMMENDATIONS

#### CHAPTER 6

#### SIMULATIONS OF ALTERNATIVE POLICY OPTIONS

##### 6.1 Methodology

Employing sample budget data from local councils in five counties, we simulated two alternative revenue-sharing scenarios and two alternative equalization grant scenarios that build on the revenue-sharing scenarios. All four scenarios keep the same level of overall transfers as 1999. Table 6-1 compares the flow and methods used for distributing transfers under the model simulations to the flow and methods for distributing actual transfers in 1999.

**Table 6-1**  
**Basis for Revenue Sharing of Wage Tax and Equalization Grants (Actual 1999 and Model Simulations)**

Model Name	Revenue Sharing of Wage Tax	Equalization Grant
Actual 1999	35% of wage tax based on origin	Distribution at the county level based on proxies for expenditures and fiscal capacity. (See Table 5-1 for exact criteria and weights.)
Model A1	25% of wage tax based on origin	Method same as Actual 1999; Pool increased by the amount which revenue sharing was decreased.
Model B1	25% of wage tax based on origin + 10% of wage tax based on population	Method and pool same as Actual 1999.
Model A2	Same as Model A1 (25% of wage tax based on origin)	Method and pool same as Model A, except that local councils with revenue shares (cote defalcate) per capita above a certain threshold are not eligible.
Model B2	Same as Model B1 (25% of wage tax based on origin + 10% of wage tax based on population)	Pool same as Actual 1999; Distribution method based solely on fiscal capacity (total revenues per capita before equalization), akin to Polish model.

Model A1 reduces the share of transfers devoted to revenue sharing of the wage tax and increases the share distributed as equalization grants by the same amount. In Model A1 equalization grants are distributed the same way as actual 1999, only in larger amounts. Model A2 builds on revenue-sharing simulation Model A1. Its method for distributing equalization grants is almost the same as actual 1999, except that it excludes local councils receiving revenue shares (cote defalcate) higher than a certain threshold per capita. Specifically, we chose 75,000 lei per capita as the commune

threshold, 150,000 lei per capita for the town threshold and 200,000 lei per capita for the municipality threshold.

Model B1 keeps the same share of transfers for revenues sharing and equalization grants as actually existed in 1999. However, Model B1 changes the method of revenue sharing so that local councils receive 25 percent of the wage tax revenues collected in their own jurisdiction and 10 percent of all wage tax revenues on a per capita basis. Model B2 builds on revenue-sharing simulation Model B1. In Model B2, equalization grants are distributed based solely on fiscal capacity. The target equalization grant will make up 90 percent of the difference between the local council's actual total revenues (before equalization) and 85 percent of the median per capita revenues for its local government type (commune, town, municipality). This method is similar to the equalization grant program in practice in Poland, described in Annex VI and illustrated in Table VI-2. To achieve this target, however, would require more transfers than actually distributed in 1999. Thus, Model B2 reduces the grant of each local council recipient by approximately 28 percent to keep within the limits of funds available.

## **6.2 Conclusions**

We use two different measures of equity to compare the model simulations with one another and with the actual distribution of 1999 transfers. The first measure is the number of “losers”—local councils that received in 1999 less than half the transfers received in 1998 in real terms. Whether or not your 1998 transfers were adequate, having them cut in half would make everyday operations—not to mention investment planning—very difficult for a local government. Therefore, the first measure is as much a measure of stability as it is of equity. The second measure is the share of local councils with total revenues per capita less than half the median for each local government type. This is a measure of relative equity—how many local governments are falling behind. Since this second measure includes own revenues it gives us an idea if the transfer system is adequately compensating for differences in local fiscal capacity.



The share of local councils in our sample that were “losers”—69 percent under the actual distribution—drops to 44 percent under both Models A1 and B1, to 43 percent under Model A2, and to 60 percent under Model B2.<sup>10</sup>

The share of local councils which had per capita revenues less than half the median was 15 percent under the 1999 actual distribution, 12 percent under Model A1, 10 percent under Model A2, 8 percent under Model B1, and 0 percent under Model B2. The results for Model A2 are slightly better than Model A1, even though Model A2 excludes many local councils from receiving equalization grants. This is because the excluded local councils had sufficient other resources. Model B2 does not allow any local council to fall so far below the median. Even though recipient local councils should have received even more under ideal conditions, the same pool of funds as in Actual 1999 was sufficient to reduce disparity considerably when appropriate changes were made to both the revenue sharing and equalization grant distribution methods.

Annex VII contains more detailed information on model simulation results.

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<sup>10</sup> The reason why Model B2 has a higher percent of losers than the other models is that it uses one standard for equalization grant eligibility for small and large communes alike. (Another standard is used for small and large towns and municipalities alike.) Because there are economies of scale in providing services, this disfavors small local councils of each type, but in particular the smallest communes with fewer than 1000 inhabitants. Under Model B2, 57 percent of the municipalities with population under 100,000 inhabitants, 74 percent of the towns and municipalities with population under 20,000 inhabitants, and 87 percent of the communes with population under 2,000 inhabitants are “losers.” There are different options for addressing this situation. One would be to create an indicator of fiscal capacity based on revenues per capita for each local government type *and* population category. This would take into account differences in economies of scale.





## CHAPTER 7 RECOMMENDATIONS

Our recommendations are based on analysis of the Romanian system, including simulations of alternative policy options, as well as lessons from other transitional countries. Annex VI includes more detailed information on the revenue sharing and equalization grant systems in the Czech Republic, Hungary and Poland and briefly explains their merits and flaws.

### **7.1 Recommendation #1: Make the Revenue Sharing System More Equitable**

The purpose of a revenue sharing system is to provide additional revenues to local governments because their own revenues are not adequate for providing basic services to their citizens. Some Romanian local governments have more than adequate revenues for providing basic services and other local governments, the vulnerable group, have less than adequate revenues. If the central government had unlimited funds, then it could increase equalization grants to make sure that the vulnerable group also had adequate revenues. However, given a hard budget constraint at the central government level, there are only two options for ensuring that the vulnerable group will have adequate revenues. Option A (Model A1) reduces the revenue shares of the wage tax retained at the local government level and puts that money into equalization grants. Option B (Model B1) distributes part of the wage tax based on origin and part on a per capita basis, which helps the vulnerable group even before equalization grants are distributed.

We recommend Model B1 over Model A1 because it does not reduce the funds for revenue sharing. It also retains a local government's incentive to share information with MoF tax offices and promote local economic development and employment, since a larger portion of the wage tax is distributed based on origin. There is no reason why distribution of the per capita portion cannot be as smooth and automatic as the distribution of the wage tax based on origin. And, because a local government knows its share of the total population, it will also be able to estimate how much it will receive from the per capita distribution of the wage tax.

*Lessons from the Czech Republic.* Revenue sharing of the personal income tax (PIT) and the corporate income tax (CIT) has promoted local autonomy and economic efficiency in the Czech Republic. However, revenue sharing by origin of the PIT has exacerbated existing differences in local fiscal capacity and even created inefficiencies as localities compete for residency of businesses. Therefore, we recommend that Romania introduce uniform per capita revenue sharing throughout the country (as with the CIT in the Czech Republic), as opposed to first distributing the shares to counties based on origin (as with the PIT in the Czech Republic) because regional variation in fiscal capacity is great in Romania.

*Lessons from Poland.* One of the lessons from Poland is that a transition period may be necessary when the government wants to institute major changes in the transfer system. If revenue sharing by origin is the goal, then local governments should be made aware of this goal and be given a schedule by which this goal will be achieved.

## **7.2 Recommendation #2: Improve Targeting of Equalization Grants**

The purpose of equalization grants is to assist a subgroup of local governments whose revenues even after revenue sharing are inadequate for providing local services. A greater emphasis on fiscal capacity will better target the equalization grants and make the system even more effective. In 1999, fiscal capacity was given a 30 percent weight in distribution of equalization grant funds. However, local councils which had the highest revenue shares per capita received almost as much in equalization grants as the local councils with the lowest revenues shares per capita. Better targeting can be accomplished either by introducing a revenues threshold (Model A2) or by making fiscal capacity the most important or the only criterion of equalization grant distribution (Model B2). Using only one criterion increases transparency in the system, eliminates arbitrary weights assigned to various criteria as well as the possibility of “missing” a criteria, and reduces the need for data collection and reporting. If indicators for the cost of providing services are included in the equalization grant formula, then activities such as water services, which should be funded by tariffs as opposed to local taxes, should not be included.

*Lessons from Poland:* The Polish central government is committed to equalization because there is a clear equalization target which all local governments understand. The Polish equalization grant system exclusively addresses fiscal capacity. By keeping equalization separate from other local government needs, the system does not become corrupted nor unnecessarily complicated.

## **7.3 Recommendation #3: Make the Revenue Shares and Equalization Grant Funds Predictable by Setting the Wage Tax Share to Judet Councils and Local Councils and Stabilizing the Pool of Funds for Equalization Grants**

Perhaps the strongest weakness in both the revenue sharing system and the equalization grant system is the unpredictability of their pool of funds. Correcting the unpredictability of these funds can most effectively be accomplished through legislation. An amendment to the Law on Local Public Finance should state that the revenue share of the wage tax (or global income tax) given to local governments already set at a certain level in this law cannot be changed annually with the Annual State Budget Law. The amendment should also stabilize the equalization grant pool by tying it to a national tax or to the national GDP. Another option for stabilizing the equalization grant pool is for the amendment to state that a certain equalization goal will be achieved.





An example of setting an equalization goal is to compensate each eligible local council for 80 percent of the difference between its actual per capita total revenues and 90 percent of the median per capita total revenues (calculated for each type of local government). Tying the equalization funds to a particular goal is very effective, but it is less desirable from the point of view of predicting how much money will be needed from the central budget. In our Model B2, we calculated equalization grants based on a goal, but then uniformly reduced the size of the grants for all recipients so as not to exceed the funds available.

*Lessons from Hungary.* The Hungarian experience in revenue sharing is very unstable. Romania should learn from Hungary's mistakes to resist the temptation of constantly changing the share of the wage tax to be distributed among local governments. Romania should also learn from Hungary's mistakes to resist the temptation of attempting to make a perfect equalizing system which can never be achieved, but in the process will confuse local government recipients with its complicated formulas and criteria.

#### **7.4 Recommendation #4: Introduce Enforcement Methods for Ensuring That County Councils Distribute Equalization Grants According to Published Criteria**

Perhaps even more important than improving the equalization grant formula is to improve the procedures for distribution of funds at the county level. A great improvement introduced in 1999 was the definition of how much of the equalization grant money can be retained at the county level and how much should be distributed among the local councils in the county. Now counties must become accountable for how they distribute those funds. We do not believe that the county must use the same formula as the central government in distributing equalization grants. However, the county council must establish a consultative process with mayors for creating criteria that are appropriate for the local councils in that county. These criteria should then be published for comment and review by the population. Distribution of the equalization grant funds should be an open process, so recipients and non-recipients understand why they are or are not receiving an equalization grant.

These principles are written in the Law on Local Public Finance, but there are no provisions for penalizing county councils that do not follow appropriate procedures for distributing equalization grants. An amendment to the Law on Local Public Finance should establish effective (financial) sanctions to county councils that are judged to have deliberately not followed appropriate procedures.

#### **7.5 Recommendation #5: Create a Regional Assistance Program to Address the Causes of Poor Fiscal Capacity**

The great regional variation in fiscal capacity today in Romania justifies the creation of a regional assistance program funded by the central government or by the European Union. Unlike an equalization grant system which attempts to compensate for differences in fiscal capacity, a regional assistance program attempts to address the causes of poor fiscal capacity. This may include an economic development program to promote business development which would result in higher wages in the region. The goal is to improve the ability of local councils to generate own revenues by strengthening their tax base.

#### **7.6 Recommendation #6: Delineate Between National, County, and Local Services and Tie Payments to Benefits Received**

The equalization grant system should not compensate for inappropriate service funding. If services should be funded by user charges, then neither local taxes nor equalization grants should be allocated for funding these services. If the services are of national interest or if the beneficiaries of the services reside in different counties, then the best way to address this is for the service to be funded directly by the central government or through a conditional matching grant. In the cases when one local council provides services for residents of other local councils in the same county, this can be addressed by (1) the county providing the service instead of the local council, or (2) the local government where the beneficiaries reside paying an appropriate fee to the local government that provides the services.

*Lessons from Poland and the Czech Republic:* In Poland, special grants completely separate from equalization grants are used to support special institutions that local councils administer for the central government. In the Czech Republic, municipalities pay other municipalities for services, particularly for students attending schools in other jurisdictions.

## ANNEX I

### INTERGOVERNMENTAL FINANCE: CONCEPTUAL FRAMEWORK

#### THE ECONOMIC RATIONALE FOR INTERGOVERNMENTAL TRANSFERS<sup>11</sup>

Intergovernmental fiscal transfers play several distinct roles in countries with decentralized governmental structures. The main economic arguments for grants<sup>12</sup> may be summarized as follows: Briefly, there are five basic economic rationales for intergovernmental transfers:

##### **(1) *Fiscal Imbalances***

For two types of imbalances that may occur the economic rationale of transfers is:

- To provide resources to close fiscal gaps arising from the assignment of revenues and expenditures. Transfers to “close the fiscal gap” (vertical fiscal balance) constitute the principal way in which this objective is generally achieved in most countries.
- To provide local governments with adequate resources to enable them to provide a specified bundle of public services. Transfers for equalization (horizontal fiscal balance) should generally be based on a measure of fiscal capacity.

A disequilibrium between tax revenue assignment and expenditure responsibilities, at different levels of government, create structural imbalances resulting in revenue shortfall, usually for lower levels of government. The reasons for this fiscal gap—or imbalance—include mostly the following factors:

- Inappropriate revenue (tax sources) and expenditure assignment.
- Limited or unproductive tax bases available to lower levels of government, making needed tax rates inefficiently high.
- Regional tax competition, for example, regional and local governments fearful of losing capital, labor, and business to other jurisdictions do not fully exploit business tax potentials and thus provide lower levels of public services.

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<sup>11</sup> This chapter draws, among others, from the work by Anwar Shaw: “The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market economies”. The World Bank (1994).

<sup>12</sup> In this chapter the terms “intergovernmental fiscal transfers” and “grants” are used as synonyms, as well as the terms “subnational” and “local”.

- Level of central government taxation limits regional and local revenue-raising potential.

To correct problems associated with the first two sources of imbalance, joint occupancy of some tax fields or decentralization of some taxes is advocated.

# **Closing the Fiscal Gap.** For various reasons, both economic and political, central governments usually have much greater revenue-raising capacity than do local governments. Intergovernmental transfers are one mechanism by which some of the revenues accruing to the central government are transferred to finance the fiscal gap of lower levels of government. Of course, such fiscal gaps may also be closed, and vertical balance restored, by transferring revenue raising-power to local governments, by transferring responsibility for expenditure to the central government, or by reducing local expenditures or raising local revenues. In most countries, however, there invariably remains sufficient mismatch in the revenue and expenditure assigned to different levels of government for an important balancing role to be assigned to intergovernmental fiscal transfers.

# **Equalization.** If horizontal fiscal balance were interpreted in the same gap-filling sense as the vertical fiscal balance discussed above, this would imply a level of transfers sufficient to equalize actual expenditures of each local government. Such “budgetary engineering” would make no sense, however. Making up all gaps between actual outlays and actual own-source revenues for all local governments, like equalizing the actual outlays of local governments in per capita terms (that is raising all to the level of the richest local government), would ignore differences in local preferences for public and private goods. It would also ignore local differences in needs, in costs, and in own revenue-raising capacity. Moreover, equalizing actual outlays would clearly discourage both local revenue-raising effort and local expenditure restraint, since under such a system those with the highest expenditure and the lowest taxes would get the largest transfers.

For these reasons, in countries with formal systems of equalization transfers, the aim is to either equalize the capacity of local governments to provide a certain level of public services or to equalize actual service performance by local governments. Transfers in some systems might be conditioned on both capacity and performance, by requiring the specified package of services to be provided. Alternatively, in a “pure” federal system in which local preferences would be assumed to dominate national preferences for local public goods, such transfers should in principle be unconditional. Another approach is to require a minimum standard of service provision and beyond this minimum subnational levels of government may have full expenditure autonomy.



# **The Capacity Approach.** This approach aims to provide local governments with adequate funds (own-source revenues plus transfers) to enable them to deliver a centrally determined level of services. It does not require service provision to a set standard. Differentials in the cost of providing services may or may not be taken into account. Transfers based solely on capacity measures generally do nothing to ensure that the recipient government will in fact use the funds they receive as the central government might wish, unless grants are conditional.

# **The Service Performance.** This criterion adjusts the transfer received in accordance with a locality's need for the aided service (it may allow for cost differentials) and is in principle more attractive to central governments and those concerned with maintaining service standards—e.g., education and social assistance programs. The level of service to be funded is determined centrally and the transfer can be made conditional on the provision of that level of service. Unfortunately, this approach suffers from the same disincentive effect on the revenue side as equalizing actual outlays, since that government which tries least again gets most; unless an adjustment is made for differential fiscal capacity.

## **(2) *Interjurisdictional Externalities***

Intergovernmental transfers can be used to correct for inefficiencies arising from interjurisdictional spillovers. The economic rationale of transfers in these cases is to face local decision-makers with correct prices with respect to externalities arising from their expenditure functions. The objective is to maximize the impact of central expenditures in certain areas by inducing local governments to spend from their own resources as well.

Spillovers usually occur because the benefits of a locally provided good or the service itself spills beyond the local jurisdiction to benefit those not contributing to the costs (air and water pollution control, locally educated students who relocate) and because nonresidents enjoy the services provided (parks, cultural, recreational, transportation facilities). In planning and administering such benefits, regional and local governments consider only their own benefits and therefore underprovide public services. To compensate, governments may redraw jurisdictional boundaries, or create separate jurisdictions for each service (McMillan 1975), but intergovernmental transfers are often the most practical means of alleviating the inefficiencies from spillovers. Open-ended conditional matching grants that modify relative prices are the most appropriate kind of transfers for implementing these corrections. The extent of cost sharing by the higher level of government should be consistent with the degree of spillover.

The rationales based on economic efficiency considerations (either because some local expenditure functions generate externalities, or because it is more efficient to administer a service locally) should generally require some local contribution (matching), with the rate of matching dependent on such factors as the degree of central interest and the estimated price and income elasticity of local demand for the services in question. These type of transfers should be conditional on the performance of the service in question in accordance with specified standards. Monitoring of local performance is obviously a matter of concern and should be specified as part of each specific program.

### **(3) *Enhancing of Internal Markets***

Common minimum standards for public services in a nation are advocated on economic efficiency grounds. Common minimum standards help reduce interregional barriers to factor and goods mobility and thereby contribute to efficiency gains. Establishing minimum standards for social services encourages labor mobility and for infrastructure capital, factor and goods mobility. Boadway (1992) has emphasized that harmonization of expenditures improves gains from interregional trade and helps foster a common internal market.

Common minimum standards for public services across different jurisdictions can be encouraged through conditional nonmatching or conditional closed-ended matching programs. Conditional nonmatching programs are preferred because they are unobtrusive, allowing subnational governments to spend grant monies as they choose, so long as they meet certain minimum standards of service and access. The higher level government simply monitors compliance with these standards.

### **(4) *Differential Net Fiscal Benefits Across Jurisdictions***

Net fiscal benefits vary from jurisdiction to jurisdiction for a number of reasons:

Some jurisdictions have more valuable natural resources and therefore better access to an enlarged revenue base.

Some jurisdictions or localities have relatively higher incomes and therefore greater ability to raise revenues from existing bases.

Some localities have inherited higher cost disability factors (low thresholds for scale economies, difficult terrain) or higher need factors (greater proportion of young, old, or poor). The presence of differential net fiscal benefits encourages fiscally induced migration. Labor and capital may move to areas with positive net fiscal benefits for fiscal considerations alone. In the process, negative externalities such as unemployment imposed on the jurisdictions they leave and enter may be ignored. The



result of fiscally induced migration is that too many of the factors will move creating social and economic problems in resource-rich areas. Factor movement in response to fiscal consideration alone create inefficiency. Treating identical persons differently by the public sector in various states creates inequity. National welfare is reduced by the externalities imposed by fiscally induced migration.

Fiscal equalization grants to eliminate or reduced differential net fiscal benefits across jurisdictions can enhance the efficiency and equity of a multi-level system. An ideal form of such a transfer is an interjurisdictional revenue pool providing negative and positive equalization grants to member jurisdictions such that the net transfer equal zero. Thus the program by design becomes self-financing. Such a grant system must be unconditional and must not reward strategic behavior to enhance positive grant entitlement or minimize negative transfer by member jurisdictions. Thus, grant design must incorporate factors over which jurisdictions have little control.

#### **(5) Stabilization**

Most recent literature on public finance argues that intergovernmental transfers can also be used to help achieve economic stabilization objectives. Grants could increase in periods of slack economic activity to encourage local expenditure and diminish during the upswing of the economic cycle. Capital grants would be a suitable instrument for this purpose. Care, however, must be exercised in ensuring that funds are available for operating expenditures associated with such initiatives.

### **CRITERIA FOR THE DESIGN OF FISCAL TRANSFERS**

# **Predictability.** The grant mechanism should ensure predictability of subnational governments' share by publishing multi-year (say, 3-5 years) projections of funding availability.

# **Simplicity/Transparency.** The subnational government's allocation should be based on objective factors over which individual units have little control. The formula should be easy to comprehend so that 'grantsmanship' is not rewarded. Furthermore, the least level of complexity in formula design, the greatest its level of transparency.

# **Non-Discretionary Budgetary Allocation.** Formula-based revenue sharing, with the share to subnational governments established in legislation, is consistent with this objective.

# **Revenue Adequacy.** Subnational governments should have adequate revenues to discharge designated responsibilities.

# **Equity.** Allocated funds should vary directly with fiscal need factors and inversely with the taxable capacity of each jurisdiction.

# **Efficiency/Autonomy.** Subnational governments should have complete independence and flexibility in setting priorities, and should not be constrained by the categorical structure of programs and uncertainty associated with decision-making at the center. Tax base sharing—allowing subnational governments to introduce their own tax rates on central bases, formula-based revenue sharing, or block grants—is consistent with this objective. The grant design should be neutral with respect to subnational governments choices of resource allocation to different sectors or different types of activity.

# **Non-Distorting of Local Tax Effort.** The design should not discourage subnational governments in their tax creation, assessment or collection.

# **Incentive for Good Financial Management.** The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance any operational deficits of subnational governments.

# **Buoyant to Economic Growth Rate.** The design should account for the central government's capacity to provide transfers. During periods of fiscal austerity, transfers to subnational governments will have to decrease. When the economy improves, transfers can increase.

# **Insulated from Partisan Politics.** The design should be perceived by all as objective and fair. Potential recipients should not be able to manipulate their eligibility nor the amount received. Grant providers should not be able to receive political favors in return for how they distributed the grants.



## ANNEX II

### MACROECONOMIC DATA

**Table II-1**  
**Macroeconomic Indicators, 1990-99**

Indicators	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999***
GDP (annual change)	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.6	-7.3	-3.5
Unemployment rate (end of period)	—	3	8.2	10.4	10.9	9.5	6.6	8.8	10.3	12
Inflation										
Average	5.1	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1	
Dec./Dec.	37.7	222.8	199.2	295.5	61.7	27.8	56.9	151.4	40.6	42
M <sub>2</sub> (end of period)-growth rate	22	101.2	79.6	141	138.1	71.6	66	104.9	48.9	
Nominal devaluation										
Average	50.3	240.5	303.1	146.8	117.8	22.8	51.6	132.5	23.8	
Dec./Dec.	140.4	444.5	143.3	177.4	38.4	45.9	56.5	98.8		
M <sub>2</sub> /GDP	55.7	27.4	20.1	13.8	13.3	18.1	20.5	18.1	36.5	
Budget deficit / GDP	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	-3.7	4.0	4
Current account/ GDP	-8.5	-3.5	-8	-4.5	-1.4	-5	-7.2	-6.7	6.6	5.5
Real wage index	5.1	-18.3	-13.0	-16.7	0.4	212.6	9.5	-22.2	6	

Notes

\* Consolidated budget

\*\* Exchange rate variation deflated by the ratio between Romanian PPI and US PPI

\*\*\* Estimates

Source: *National Bank of Romania*

**Table II-2**  
**Fiscal and Quasi-Fiscal Deficit (in percent of GDP)**

	1993	1994	1995	1996	1997
<i>Budget balance</i>					
Total					
Cash	-0.4	-1.9	-2.6	-3.9	-4.5
Accruals	-0.4	-1.9	-3.0	-5.8	-3.5
Primary					
Cash	0.6	-0.5	-1.2	-2.2	-0.5
Accruals	0.6	-0.5	-1.6	-4.1	0.5
Quasi-fiscal deficit NBR refinancing	-3.1	-3.6	-0.3	-2.6	0.0
<i>Budget balance including quasi-fiscal deficit</i>					
Total					
Cash	-3.5	-5.5	-2.9	-6.5	-4.5
Accruals	-3.5	-5.5	-3.3	-8.4	-3.5
Primary					
Cash	-2.5	-4.1	-1.5	-4.8	-0.5
Accruals	-2.5	-4.1	-1.9	-6.7	0.5
Memorandum item					2
Interest payment	0.9	1.4	1.4	1.7	4

Source: *National Bank of Romania*

**Table II-3**  
**Structure of Loans in the Banking System**

	31. 12.94	31.12.95	31.12.96	31.12.97	30.06.98
Standard	35.7	16.8	11.1	13.6	10.9
Watch	29.8	26.9	27.7	21.3	19.8
Substandard	11.7	14.0	18.2	12.5	11.2
Doubtful	11.9	13.7	10.1	9.9	7.5
Loss	10.9	28.5	32.9	42.6	50.6
<b>Memo:</b>					
The last three	34.5	56.3	61.2	65.0	69.3

Source: National bank of Romania (*The Bulletin*)

**Table II-4:**  
**Comparative Study of Government Revenues (Total Revenue) for Selected Eastern European Countries, 1990-1997 (in percent of GDP)**

	1990	1991	1992	1993	1994	1995	1996
Romania	39.7	41.9	37.4	33.9	32.1	31.9	29.6
Albania	46.8	31.5	23.5	25.6	24.5	24.0	—
Bulgaria	52.9	40.4	38.4	37.2	39.9	36.2	33.6
Czech Republic	—	—	48.2	50.5	49.4	48.4	—
Hungary	52.1	50.9	50.0	50.7	49.6	46.6	45.8
Poland	45.4	42.4	43.9	47.6	47.2	47.2	45.7
Slovak Republic	—	—	46.1	44.2	46.3	46.8	—

Sources: Country authorities; and IMF estimates.

## **ANNEX III**

### **CHANGES IN LOCAL EXPENDITURES AND REVENUES**

The functions of local governments<sup>13</sup> include: education (materials, services and capital expenditures), health (material and services), cultural activities and sports, social assistance (personnel expenditures, materials, services, and capital expenditures), public services, transport and communications, economic activities, and agriculture (personnel expenditures, materials and services and capital expenditures). Counties, in contrast to municipalities, towns, and communes, have in practice less local functions and do not play a role in those local functions, related to education, health and agriculture.

Local revenue sources are comprised of: local taxes and fees, revenue sharing (on the national wage tax), fiscal equalization grants, and non-fiscal revenues primarily from enterprises. Local taxes and fees mainly include the local profit tax, the land and building tax, the vehicle tax, and fees for use of state property.

Consolidated local government expenditures as a proportion of GDP is about 4.0 percent. It has evolved from 3.5 percent in 1994 to 4.0 in 1998. The estimated figure for 1999 remains at the same level of that for 1998 (Table III-1). However, it must be noted that in 1996 the share of LG expenditures in GDP had a maximum level of 4.7 percent. The trend for the six-year period (1994-1999) is slightly positive. Of course, if the period of analysis took year 1996 (the maximum level) as the starting point, it could be argued that the trend has been since then slightly negative. On average the share for the six-year period has been about 4.2. Therefore, it could be also argued that the most recent share of 4.0 percent is slightly below average for the period 1994-1999

The share of central government expenditures as a proportion of GDP has been estimated at 19.7 percent for this year. It has evolved from 22.0 percent in 1994 to the above magnitude. The highest share of 22.9 percent of CG expenditures as a proportion of GDP occurred in 1998. However, examining the trend for the six-year period (1994-1999), with the exception of 1998, it may be argued, that it has been negative. Comparing the trend in the relative shares of LG and CG expenditures as a proportion of GDP it may be argued that the downward adjustment has been greater for the CG. The average relative weight of CG expenditures with respect to GDP, for the analyzed period, has been 21.5 percent. As such, the estimated level of 19.7 for this year is substantially below the average for the period. This magnitude reflects the cuts in the national fiscal deficit.

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<sup>13</sup> Local governments are comprised by municipalities (cities), towns (towns), and communes (villages). Counties refer to the regional governments.

**Table III-1**  
**Macroeconomic Context for Local Governments**

	1994	1995	1996	1997	1998	1999
<i>Macroeconomic Indicators (billions of current lei)</i>						
GDP	49,773	72,560	109,515	249,750	338,670	474,830
General Government Expenditure <sup>a</sup>	16,892	25,061	36,810	85,568	131,122	170,243
Central State Expenditure	10,930	15,858	23,732	52,897	77,617	93,384
Local Government Expenditure	1,735	3,265	5,109	10,468	13,454	19,169
Local Government Transfers from CG <sup>b</sup>	1,431	2,403	3,822	8,435	10,052	10,367
Equalization Grant Revenues to LG <sup>c</sup>	0	0	0	0	0	1,065
<i>Ratios (percent)</i>						
GG expenditures/GDP	33.9	34.5	33.6	34.3	38.7	35.9
CG expenditures/GDP	22.0	21.9	21.7	21.2	22.9	19.7
LG expenditures/GDP	3.5	4.5	4.7	4.2	4.0	4.0
LG Expenditures/General Government	10.3	13.0	13.9	12.2	10.3	11.3
LG expenditures/CG expenditures	15.9	20.6	21.5	19.8	17.3	20.5
Fiscal Transfers/GDP	2.9	3.3	3.5	3.4	3.0	2.2
Transfers to LG/CG Expenditures	13.1	15.2	16.1	15.9	12.9	10.0
Equalization Grants/CG Expenditures						1.1
Inflation (Annual Average)	61.7	27.8	56.4	151.4	40.6	34.7
Price index: 1999 = 100	437.9	376.2	348.4	292.0	140.6	100.0

**Notes**

a Including local government revenues

b Shared wage-tax, investment, social protection revenues and equalization grants.

c Equalization grants were introduced in 1999. They are a subset of the national transfers to local governments.

Sources: Romania, Country Report 1st Quarter 1999. The Economist Intelligence Unit and Ministry of Finance (MOF), Budget Department.

Comparing the relative magnitudes of the effects of the fiscal adjustment on the central and local governments, it may be argued that over the six-year period, LGs increased their share in GDP in half of a percent, while the CG dropped its share in 2.3 percent. If the most recent adjustment (from 1998 to 1999) stays as predicted, it would mean a drop of 3.2 percent in the share of the CG, while the share for LGs would remained stable.

Examining the intergovernmental fiscal relations, in particular the transfers from the CG to the LGs as a proportion of GDP, the results indicate that their average relative weigh for the period 1994-1999 is about 3.0. Fiscal transfers (including subsidies) have had a negative trend over the six-year period. They were equivalent to about 2.9 in 1994 and are estimated at 2.2 for 1999. The maximum share of overall



fiscal transfers of 3.5 percent occurred in 1996. Since then, their share has been dropping. From 1998 to 1999 they are expected to drop 0.8 percent points as a proportion of GDP.

Comparing the drop in CG transfers (including subsidies) to LG with the drop in CG expenditures, both of them as a proportion of GDP, it may be argued that the drop was larger for CG expenditures than it was for CG overall transfers to LGs. The former dropped by 3.2 percent points, while the latter fell by 0.8 percent points, as analyzed above. From this perspective, it may be argued that the fiscal adjustment has been more severe for the CG than for the LGs. These findings seem to suggest that despite the fiscal adjustment the relative fiscal balance (i.e., the *vertical* balance between the CG and the LGs) has changed in favor of the LGs and against the CG.

During the period 1994-1999, overall fiscal transfers as a proportion of the CG expenditure budget have been, on average, equivalent to about 14.1 percent. Their highest relative share of 16.1 percent occurred in 1996. The trend in the share of fiscal transfers has been slightly negative. They have dropped 3.1 points of a percent from 13.1 in 1994 to an estimate of 10.0 in 1999. The fiscal adjustment in the fiscal transfers (including subsidies) from 1998 to 1999 was equivalent to a drop of 2.9 percent, their share went from 12.9 to 10.0 percent.

In summary, it is estimated that the fiscal adjustment between 1998 and 1999 will be reflected in a drop of 3.2 percent points in the ratio CG/GDP; a drop of 2.0 percent points in the ratio Transfers/CG, and no drop on the ratio LG/GDP. This latter ratio, it has been estimated, that will remain stable at the 4.0 percent level. This last result implies that for LGs to be able to keep a constant share in GDP, must have increased their own revenue sources to compensate for the fiscal adjustment. As it will be discussed below, LGs estimate a net increase in local taxes for 1999 of about 3,000 billion lei. In this sense, LG finances seem to be in a relatively better shape than the fiscal situation for the central government. The data suggest that the implicit changes in the *vertical* fiscal balance between the CG and the LGs, have affected more severely the finances of the Central Government.



## ANNEX IV

### CHANGES IN THE HORIZONTAL BALANCE

#### OWN REVENUES

Table IV-1 compares the basic local budget structure of our sample—divided into own revenues and state transfers—for the years 1998 and 1999. For all types of local councils, own revenues became a much larger share of total revenues in 1999. It is surprising that own revenues form the largest budget share in communes, because one would expect that rural areas would have the weakest fiscal capacity.

**Table IV-1**  
**Revenues by Source, 1998 and 1999 by Type of Political-Administrative Jurisdiction and by Population Size**

Political-Administrative Jurisdiction / Population	(N)	OWN REVENUES (%)		TRANSFERS (%)	
		1998	1999	1998	1999
<i>Total</i>	325	20	61	80	39
<i>Municipalities</i>	11	29	57	71	43
< 100.000	7	28	56	72	44
> 100.000	4	32	57	68	43
<i>Towns</i>	23	21	59	79	41
< 10.000	8	22	54	78	46
10.000 - 20.000	11	26	62	74	38
> 20.000	4	18	53	82	47
<i>Communes</i>	291	19	61	81	39
< 1.000	8	13	53	87	47
1.000 - 3.000	114	16	54	84	46
3.000 - 5.000	106	20	65	80	35
> 5.000	63	23	65	77	35

Table IV-2 presents the two dynamics that explain the shift in the local budget structure: total own revenues more than doubled in real terms—from 298 billion lei to 614 billion lei, while transfers decreased by almost 30 percent—from 751 billion lei to 541 billion lei. Small municipalities and communes of all population categories suffered great losses in transfers while larger towns and municipalities suffered little or no loss in transfers.

**Table IV-2**  
**Real Growth in Own Revenues and Real Decrease in Transfers, 1998 to 1999 by Type of Political-Administrative Jurisdiction and by Population Size (1000 lei)**

Political-Administrative Jurisdiction / Population	(N)	OWN REVENUES		TRANSFERS	
		1998 (in 1999 lei)	1999	1998 (in 1999 lei)	1999
		<i>Inflation factor</i>	<i>1</i>	<i>1.395</i>	<i>1</i>
<i>Total</i>	325	298,435,067	613,961,182	843,732,110	540,557,869
<i>Municipalities</i>	11	163,267,198	338,073,797	404,891,746	309,578,829
< 100,000	7	52,518,410	84,189,180	136,050,584	51,712,129
> 100,000	4	110,748,788	253,884,617	268,841,162	257,866,700
<i>Towns</i>	23	64,243,261	118,270,343	163,292,481	134,454,419
< 10,000	8	13,777,379	31,922,987	45,203,167	35,291,519
10,000 – 20,000	11	40,649,111	32,943,475	70,089,809	39,270,851
> 20,000	4	9,816,771	53,403,881	47,999,505	59,892,049
<i>Communes</i>	291	70,924,608	157,617,042	275,547,883	96,524,621
< 1,000	8	906,686	1,900,909	5,519,096	1,591,043
1,000 – 3,000	114	20,624,937	42,136,375	102,593,035	29,177,675
3,000 – 5,000	106	29,384,499	63,772,220	110,666,840	33,107,416
> 5,000	63	20,008,486	49,807,538	56,768,913	32,648,487

Variation in the ability to increase own revenues appears to be stronger among regions than among urban/rural type of local government. In one county, only 6 percent of the communes and none of the towns and municipalities were able to double their own revenues in real terms. In another county, 92 percent of the communes and all of the towns and municipalities doubled their own revenues (Table IV-3). It is interesting that these two counties representing the extremes are also the most rural counties in the sample. Thus, although fiscal capacity does vary considerably from region to region, one cannot assume that a local council in a more rural county will have poorer fiscal capacity than a similar type local council in a more urban county.

**Table IV-3**  
**Own Revenue Dynamics from 1998 to 1999 by County and by Type of Local Government**

	(N)	Share of communes with 1999 own revenues more than 200 % 1998 level (in real terms)		Share of towns and municipalities with 1999 own revenues more than 200 % 1998 level (in real terms)	
		(N)		(N)	
<i>Total</i>	291	54%	34	50%	
County 1	49	92%	3	100%	
County 2	52	65%	13	62%	
County 3	39	67%	5	20%	
County 4	82	59%	7	71%	
County 5	69	6%	6	0%	





Although many communes were able to increase own revenues, they still have a smaller tax base, so their own revenues are generally far below the own revenues of towns and municipalities, even on a per capita basis. The median own revenues for local councils in the sample was 120,000 lei per capita for communes and 277,000 lei per capita for towns and municipalities (Table IV-4). There is also regional variation in median per capita own revenues. It is not surprising that the county with the highest median per capita own revenues for communes was also the county in which almost all of the communes doubled their own revenues. Likewise, the county with the lowest median per capita own revenues for communes was also the county in which only 6 percent of communes doubled their own revenues. In only one county are median per capita revenues for communes higher than those of towns and municipalities.

**Table IV-4**  
**1999 Median Per Capita Own Revenues (1000 lei) by County and by Type of Local Government**

	(N) communes	Median per capita own revenues for communes	(N) towns and municipalities	Median per capita own revenues for towns and municipalities
<i>Total</i>	291	120	34	277
County 1	49	187	3	275
County 2	52	182	13	357
County 3	39	144	5	128
County 4	82	112	7	314
County 5	69	42	6	114

## CENTRAL TRANSFERS

Variation in transfers received show a very strong urban and rural divide. In 1998, a county's share of total transfers closely correlated with its share of total population. In 1999, the transfer share to more rural counties was cut in half, while the transfer share to the most urban county nearly doubled (Table IV-5).

**Table IV-5**  
**Comparison of Share of Total Transfers, 1998 to 1999 by County**

By County	Percent of county population that is urban	Percent population of the sample	1998 Share of total transfers in the sample (%)	1999 Share of total transfers in the sample (%)
<i>Total</i>	100	100	100	100
County 1	8	12	14	7
County 2	43	32	35	61
County 3	20	16	19	5
County 4	17	26	23	21
County 5	12	13	10	5

Both the sample and nationwide data provided by the Budget Department of the Romanian Ministry of Finance show that municipalities increased their share of the transfer pool and communes saw a decrease in their share. The nationwide data indicate that the share to towns decreased, while data in our sample indicate that the share increased.

In 1999, the median per capita transfers received by towns and municipalities in the sample (209,000 lei per capita) was nearly three times the level received by communes in the sample (72,000 lei per capita) (Table IV-6). For communes there is much less variation among counties in transfers received than there is in own revenues generated. For towns and municipalities, the variation among counties in transfers received and in own revenues is about the same.

**Table IV-6**  
**1999 Median Per Capita Transfers Received (1000 lei) by County and by Type of Local Government**

	(N) communes	Median per capita transfers received for communes	(N) towns and municipalities	Median per capita transfers received for towns and municipalities
<i>Total</i>	291	72	34	209
County 1	49	88	3	196
County 2	52	94	13	251
County 3	39	75	5	343
County 4	82	67	7	281
County 5	69	70	6	91



The combined impact of the decrease in aggregate transfers and a redistribution of the transfer pool created many “losers.” We classify local councils as “losers” if they received less than half as much in 1999 total transfers than in 1998 in real terms. Table IV-7 shows that 70 percent of the communes and 56 percent of towns and municipalities were “losers.”

**Table IV-7**

**Losers: Local Councils Receiving Less than Half Their 1998 Transfers in Real Terms by County and by Type of Local Government**

	(N)	Share of communes with 1999 transfers less than 50 % 1998 level (in real terms)	(N)	Share of towns and municipalities with 1999 transfers less than 50 % 1998 level (in real terms)
<i>Total</i>	291	69%	34	50%
County 1	49	80%	3	67%
County 2	52	50%	13	46%
County 3	39	41%	5	60%
County 4	82	68%	7	29%
County 5	69	94%	6	67%

## TOTAL REVENUES

Because own revenues vary strongly by region and transfers vary strongly by urban/rural type of local government, total revenues vary both by county and by type. Median total revenues are 207,000 lei per capita for communes and 490,000 lei per capita for towns and municipalities. The median per capita revenues for communes in the poorest county are less than half the level for the richest county (Table IV-8).

**Table IV-8**

**1999 Median Per Capita Total Revenues (1000 lei) by County and by Type of Local Government**

	(N) communes	Median per capita total revenues for communes	(N) towns and municipalities	Median per capita total revenues for towns and municipalities
<i>Total</i>	291	207	34	490
County 1	49	279	3	398
County 2	52	260	13	584
County 3	39	217	5	497
County 4	82	185	7	706
County 5	69	117	6	194

In Table IV-9 we compare inequity in 1998 and 1999 as the share of local councils with less than half the median per capita total revenues for similar local government types.<sup>14</sup> This table shows that inequity in total revenues per capita grew slightly for communes from 12 percent in 1998 to 13 percent in 1999, and dramatically for towns and municipalities, from 12 percent in 1998 to 26 percent in 1999. We cannot blame the growing inequity on the transfer system since we know that the gap in own revenues widened greatly between 1998 and 1999. *However, the transfer system should attempt to increase equity by compensating for the growing gap in own revenues.*

Comparing a local government's current transfers with its previous transfers tells us if the system change benefited or hurt a local council. Comparing a local council's total revenues with the median for similar local governments describes the combined impact of both the system change and other changes occurring at the same time. Both are valid measures for evaluating the equity impact of implementing the Law on Local Public Finance in 1999.

**Table IV-9**  
**Share of Local Councils with Per Capita Revenues 50 Percent Below Median, 1998 and 1999 by County and by Type of Local Government**

	1998	1999	1998	1999
	Share of communes with per capita total revenues less than 50% of the median	Share of communes with per capita total revenues less than 50% of the median	Share of towns and municipalities with per capita total revenues less than 50% of the median	Share of towns and municipalities with per capita total revenues less than 50% of the median
<i>Total</i>	12%	13%	12%	26%
County 1	2%	0%	0%	0%
County 2	15%	4%	23%	23%
County 3	23%	0%	20%	40%
County 4	17%	13%	0%	0%
County 5	4%	38%	0%	67%

<sup>14</sup> We calculated a separate median for communes than for towns and municipalities because we expect differences in functions and in economies of scale of delivering services that will determine the per capita levels of revenues needed.

## ANNEX V

### ANALYSIS OF EQUALIZATION GRANT RECIPIENTS

**Table V-1**

**Share of Local Councils Receiving Equalization Grants, 1999 by Type of Political-Administrative Jurisdiction and by Population Size**

Political-Administrative Jurisdiction (Population Size)	Percent share of equalization grant recipients among <i>all</i> local councils	Percent share of equalization grants among local councils with the <i>least</i> revenue shares per capita <sup>a</sup>	Percent share of equalization grants among local councils with the <i>most</i> revenue shares per capita <sup>b</sup>
<i>Total</i>	86	98	69
<i>Municipalities</i>	82	100	75
< 100,000	100	100	100
> 100,000	50	100	50
<i>Towns</i>	70	88	38
< 10,000	63	100	0
10,000 – 20,000	73	86	50
> 20,000	75	—	50
<i>Communes</i>	88	99	71
< 1,000	100	100	100
1,000 – 3,000	95	100	85
3,000 – 5,000	90	100	68
> 5,000	70	92	52

**Notes**

a Local councils receiving the lowest third (calculated separately for municipalities, towns and communes) in per capita revenue shares.

b Local councils receiving the highest third (calculated separately for municipalities, towns and communes) in per capita revenue shares.

**Table V-2**

**Share of Total Equalization Grants for Local Councils Benefiting the Least and the Most from Revenue Sharing, by Type of Political-Administrative Jurisdiction (1999)**

Political-Administrative Jurisdiction	(N)	Share of total equalization grant money given to local councils with the <i>least</i> revenue shares per capita (percent) <sup>a</sup>	(N)	Share of total equalization grant money given to local councils with the <i>most</i> revenue shares per capita (percent) <sup>b</sup>
<i>Total</i>	108	32	108	28
Municipalities	4	39	4	46
Towns	8	28	8	26
Communes	96	32	96	25

**Notes**

a Local councils receiving the lowest third (calculated separately for municipalities, towns and communes) in per capita revenue shares.

b Local councils receiving the highest third (calculated separately for municipalities, towns and communes) in per capita revenues shares.



## ANNEX VI

### LESSONS IN DESIGNING FISCAL TRANSFERS FROM OTHER COUNTRIES IN THE REGION

The purpose of this chapter is to present examples of revenue sharing and equalization grant systems from three other countries in the region—Czech Republic, Hungary, and Poland—and to briefly explain the merits and flaws of these systems.

#### CZECH REPUBLIC <sup>15</sup>

The lessons for Romania from the experience of the Czech Republic are clear. Revenue sharing of the wage tax can promote local autonomy and economic efficiency. However, revenue sharing by origin can exacerbate existing differences in local fiscal capacity and even create inefficiencies as localities compete for residency of businesses.

#### *Revenue Sharing*

In the Czech Republic, revenues from shared taxes (revenue sharing) represent 53 percent of municipal budgets—one of the highest shares in the region. (See Table VI-1) Generous revenue sharing arrangements partly explain this. Another reason is that all taxes are categorized as revenue sharing, as opposed to own revenues, because the central government is solely responsible for setting the tax rates. This is true even for the real estate tax, of which 100 percent of the revenues is retained by local governments. The central government continues to control tax rates in order to achieve its macroeconomic plan of low overall taxation to support economic growth. The central government reasons that, given greater authority in setting tax rates and introducing new taxes, local governments might raise the overall tax burden on businesses and entrepreneurs. The impact of high revenue shares is considerable freedom in spending decisions for municipalities, but very little freedom in influencing revenue levels.

The generous Czech revenue sharing system includes distribution of 20 percent of the corporate income tax (CIT) and 20 percent of the personal income tax (PIT) to municipalities<sup>16</sup> on a per capita basis. The CIT is distributed on a uniform per capita basis throughout the country. The PIT, on the other hand, is first distributed among districts according to where that tax is collected. Of the 60 percent of the PIT distributed

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<sup>15</sup> This section is drawn from *Fiscal Decentralization in the Czech Republic*, a paper prepared by Vera Kamenickova for the Urban Institute in June 1999. At the time that Ms. Kamenickova drafted this paper she was an official at the Ministry for Local Development. She currently works for Urban Research in Prague, Czech Republic.

<sup>16</sup> In the Czech Republic, all local councils are called municipalities regardless of their size.

to districts (okres) based on tax collection, half (30 percent of the PIT) is retained by the district level of government. The remaining 30 percent is distributed to municipalities—20 percent distributed on a per capita basis and 10 percent based on origin.

**Table VI-1**  
**Structure of Local Council Revenues (Percent Share)**

	Bulgaria (1998)	Czech Republic (1997)	Hungary* (1998)	Poland (1997)	Romania (1999 – estimate)
<i>Own Revenues</i>	17.2	25.0	29.8	15.9	56.4
Revenue Sharing (Shared Taxes)	46.2	53.1	14.7	43.7	34.5
Transfers	36.6	21.9	52.9	38.2	8.6
Other	—	—	2.6	2.3	0.5
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>

Note

\* For Hungary, county revenues are included.

Sources: *Bulgaria: Options for Changes in the Intergovernmental Transfers System* (James S. McCullough), *Local Governments in the Czech Republic* (Zdenka Matouskova), *Fiscal Decentralization and Local Government Finance in Hungary, 1989-1999* (Juliana H. Pigey), *The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland, 1989-1999* (Tony Levitas), Budget Department of the Ministry of Finance, Romania

The greatest flaw in the Czech revenue-sharing system is the disequilibrium or disparity in revenues it creates because the PIT is first distributed among districts based on origin. The PIT consists of wage tax, tax on incomes of self-employed individuals and tax on capital gains. As in Romania, the wage tax is collected at the place of payroll, as opposed to where the worker resides. However, in the Czech system the payroll location or even the “permanent domicile” of the individual entrepreneur can be arbitrary and not related to the location of the actual economic activity. The four principal cities—Praha, Brno, Ostrava and Plzn—which also have district status, receive 60 percent of the district revenue collection from the wage tax while many of the 6000 other municipalities are left with inadequate revenues. Furthermore, in order to increase their wage tax share, municipalities compete to be the residence of businesses by granting subsidies which in the end drains their total revenues.

The greatest accomplishment of the Czech revenue-sharing system is the significant shift from earmarked transfers that stifle local autonomy and economic efficiency to revenue sharing which gives municipalities greater freedom in spending decisions.





### **Equalization Grants**

The Czech Republic does not have a formal equalization grant system because the revenue sharing system both is generous and has an equalizing impact. Beyond this, cost differentials across localities for service delivery are taken into account for sector grants provided for specific services. The Czech Republic also has a State Environmental Fund (SEF) which provides loans for capital investment in infrastructure projects that improve the environment. These loans are either interest free or have below-market interest rates, which constitute a type of grant. Small municipalities in particular are likely to benefit from SEF loans because the central government recognizes that it would be difficult for them to obtain commercial loans.

### **HUNGARY <sup>17</sup>**

There are two main lessons for Romania from the experience of Hungary. The first is to resist the temptation of constantly changing the share of the wage tax to be distributed among local governments. The second is to resist the temptation of attempting to make a perfect equalizing system which can never be achieved, but in the process will confuse local government recipients with its complicated formulas and criteria.

### **Revenue Sharing**

There are three shared taxes in Hungary, of which the personal income tax (PIT) is by far the most important. Fifteen percent of the PIT is distributed directly to local governments based on origin (residence). Municipalities collect the motor vehicle tax and remit 50 percent to the central government. County administration offices collect the tax on property transactions, distributing 30 percent to the municipality of origin, 35 percent to the county administration office for expenses, and 35 percent to a pool, distributed to counties on a per capita basis. All together, direct revenue sharing forms only 15 percent of Hungarian local budgets, much below the level of other countries in the region (Table VI-1).

The greatest flaw of the Hungarian revenue-sharing system is the unpredictability of the share distributed directly to local governments. The share of the PIT distributed directly to local governments has changed frequently, ranging from a high of 100 percent in 1990 to a current low of 15 percent. The local government share is subject to annual decisions in the State Budget Law.

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<sup>17</sup> This section is drawn from *Fiscal Decentralization and Local Government Finance in Hungary, 1989-1999* prepared in August 1999 by Juliana H. Pigey, a municipal finance analyst at the Urban Institute.

## **Equalization Grants**

In 1999, 25 percent of the personal income tax was distributed to local governments on a normative basis. Since 1995, the Hungarian government has reduced the portion of the PIT for direct revenue sharing and increased the portion of the PIT for normative distribution. However, less than one third of the PIT reserved for normative distribution (or 7.6 percent of the PIT in 1999) is used for equalization according to a clear and transparent formula.

According to an equalization formula, Hungarian local governments are guaranteed a minimum per capita revenue level from their personal income tax share. In 1999 the guaranteed minimum per capita PIT revenue level was the same for villages and cities, but it can differ according to local government type. In 1998, the minimum level for cities was 22.5 percent higher than the minimum level for villages. Each year the minimum per capita level increases to account for inflation. The strength of this system is that it is clear and simple. By equalizing based on a national tax—the PIT, the equalization grant program also is less likely to reduce local tax incentives.

The greatest flaw of the Hungarian system for equalizing among local governments is the lack of transparency in distribution of the remaining normative share. In 1998 approximately 50 normatives linked mostly to expenditure needs were used to calculate the distribution of equalizing revenues to local governments. Some of these normatives are a fixed amount for each type of local government, some are a per capita amount, while others are linked to the number of beneficiaries of services. Although these very complicated formulas are a rational attempt to model every cost differential in local governments, the result is that local governments find it practically impossible to estimate how much revenues they are likely to receive in a given year.<sup>18</sup>

Finally, another problem with the Hungarian intergovernmental fiscal system is its high share of earmarked transfers that reduce economic efficiency and local autonomy by taking away from local governments control over spending decisions. On the other hand, Hungarian local governments have more influence over their revenues than those in the Czech Republic and Poland, because they have the option to levy five types of local taxes and they can set the tax rate for these taxes within a centrally defined rate ceiling.

## **POLAND <sup>19</sup>**

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<sup>18</sup> William F. Fox, *Intergovernmental Finance in Hungary: Summary and Evaluation*, a report prepared for the Urban Institute, 1998.

<sup>19</sup> This section is drawn from *The Political Economy of Fiscal Decentralization and Local Government Finance Reform in Poland, 1989-1999* (July 1999 draft), prepared for the Urban Institute by Tony Levitas, a consultant with Research Triangle Institute.



One of the lessons from Poland is that a transition period may be necessary when the government wants to institute major changes in the transfer system. If revenue sharing by origin is the goal, then local governments should be made aware of this goal and be given a schedule by which this goal will be achieved. Another lesson from Poland is that the central government will be more committed to equalization where there is a clear equalization target which all local governments understand. Also, an equalization target relative to the national average automatically adjusts to the economic situation in the country.

### **Revenue Sharing**

As in the Czech Republic, the Polish Ministry of Finance sets the rates for almost all taxes and fees, even when these taxes are retained 100 percent by the local councils. This explains Poland's relatively high portion of the local budget from revenue sharing and the relatively low portion from own revenues. Polish local councils, known as *gminas*, receive 17 percent of the personal income tax (PIT) and 5 percent of the corporate income tax (CIT). Similar to the Czech system, the PIT is first distributed among counties based on origin and then distributed to the *gminas*, partially on a per capita basis and partly based on origin. Because farmers were not included in the PIT reform, a direct distribution of revenue shares based on origin would produce trivial revenues for rural *gminas*. The Polish government thus created a transition policy for revenue sharing to shift from a per capita basis to an origin basis. In the beginning of the transition, all revenue-sharing was distributed on a per capita basis within counties. In each stage of the transition, the portion distributed on a per capita basis decreases and the portion distributed based on origin increases. By the year 2000, revenue sharing of PIT will be 100 percent based on origin.

The greatest strength in Poland's revenue-sharing system has been the consistency of the local government shares for both the PIT and the CIT. The greatest flaw in Poland's revenue-sharing system is the unpredictability of the pool of funds. Although the central government has kept the local government share of the PIT fairly stable over time, it has interfered in the total collection by changing the tax rate and granting exemptions and abatements. In this way, local governments do not have control over their level of revenues coming from the PIT.

In addition to the 17 percent of the PIT distributed to *gminas* through counties, PIT revenues are distributed to large cities based on a "U" coefficient. This extra money provided to large cities, could be considered an additional type of equalization grant, since the equalization grant in the Polish system (described below) does not guarantee greater per capita revenues for larger cities even though they may provide additional services.

## Equalization Grants

Polish local governments receive a block grant (a transfer of non-earmarked funds) which has four components. The four components are investment grants, needs grants, equalization grants and primary education grants, with the latter two types of grants being much larger than the former two types. The equalization grant takes into account the national average per capita revenues in calculating the equalization grants. The more a *gmina*'s per capita revenues fall below the national average, the greater the equalization grant it receives. One can imagine that this would greatly discourage a *gmina* from increasing own revenues because an increase in own revenues would spell a decrease in equalization grants. The Polish system attempts to get around this problem by making sure that the fall in equalization grants revenues would be less than the increase in own revenues. This is done by granting *gminas* only 90 percent of the difference between its actual per capita revenues and the target per capita revenues. Also, the target per capita revenues is set below the median, which helps to ensure that money is given to the most vulnerable *gminas*. Table VI-2 provides hypothetical examples for calculating the equalization grants in Poland.

**Table VI-2**  
**Hypothetical Examples of Calculating Poland's Equalization Grants (Example assumes national average of total local revenues at 500 Zloty per capita)**

1	2	3	4	5
Total per capita revenues of a <i>gmina</i> before equalization	Target: 85% of national average (.85 * 500)	Difference between column 2 and column 1	Per capita equalization grant (90% of column 3, if positive value)	Total per capita revenues of a <i>gmina</i> after equalization
430	425	-5	—	430
300	425	125	113	413
250	425	175	158	408
150	425	275	248	398

The greatest strength of Poland's equalization grant system is its transparency to recipients. Its straight-forward and clearly understood objective also helps to make the central government consider it a serious obligation. Another strength of the system is its buoyancy. Unlike the Hungarian equalization formula, the Polish equalization formula automatically allows for changes in the country's current economic situation.

## ANNEX VII

### MODEL SIMULATION RESULTS

#### REVENUE SHARING SIMULATIONS

The resulting per capita total revenues under Model A1 and B1 and for actual 1999 are presented in Table VII-1. Both Models A1 and B1 raise the overall median per capita revenues for communes and for towns and municipalities of our sample. However, the median does not indicate the effect on vulnerable local councils, so we also employ measures of equity.

**Table VII-1**  
**Median Total Per Capita Revenues (1000 lei), Summary Table by County and by Type of Local Government**

	(N)	Actual 1999	Model A1	Model B1
<i>Communes</i>	291	207	260	249
County 1	49	279	345	324
County 2	52	260	335	298
County 3	39	217	251	260
County 4	82	185	220	232
County 5	69	117	190	167
<i>Towns and Municipalities</i>	34	490	549	503
County 1	3	398	409	415
County 2	13	584	726	621
County 3	5	497	578	531
County 4	7	706	625	678
County 5	6	194	197	223

Models A1 and B1 improve upon the actual distribution of 1999 transfers in terms of our two measures of equity: (a) the number of “losers”—local councils that received in 1999 less than half the transfers received in 1998 in real terms; and, (b) the number of local councils with total revenues per capita less than half the median for its local government type.

Table VII-2 presents the share of local councils that are “losers” under actual distribution of transfers in 1999 and under the two models. The share of local councils that were “losers”—69 percent under the actual distribution—drops to 44 percent under both Models A1 and B1.

**Table VII-2**  
**Share of Local Councils with 1999 Transfers Less Than Half Their 1998 Transfers (in Real Terms)**  
**by County and by Type of Local Government**

	(N)	Actual 1999 (%)	Model A1 (%)	Model B1 (%)
<i>Total</i>	325	69	44	44
<i>Communes</i>	291	70	44	43
County 1	49	80	61	59
County 2	52	50	31	33
County 3	39	41	18	18
County 4	82	68	44	30
County 5	69	97	55	68
<i>Towns and Municipalities</i>	34	56	44	50
County 1	3	67	67	67
County 2	13	46	23	31
County 3	5	60	40	60
County 4	7	29	29	29
County 5	6	100	100	100

Table VII-3 presents the share of local councils that have total revenues per capita less than half the median value for its urban/rural type. The share of local councils which had per capita revenues less than half the median was 15 percent under the actual distribution, 12 percent under Model A1, and 8 percent under Model B1. The greatest decrease in share of vulnerable communes occurs in the poorest county; however the share of vulnerable towns and municipalities in the same county does not decrease.

**Table VII-3**  
**Share of Communes with Per Capita Revenues 50 Percent Below Median, Summary Table by**  
**County and by Type of Local Government**

	(N)	Actual 1999 (%)	Model A1 (%)	Model B1 (%)
<i>Total</i>	325	15	12	8
<i>Communes</i>	291	13	11	6
County 1	49	0	2	0
County 2	52	4	4	4
County 3	39	0	0	0
County 4	82	13	15	5
County 5	69	38	23	17



**Table VII-3 (Continued)**

	(N)	Actual 1999 (%)	Model A1 (%)	Model B1 (%)
<i>Towns and Municipalities</i>	34	26	24	24
County 1	3	0	0	0
County 2	13	23	15	15
County 3	5	40	40	40
County 4	7	0	0	0
County 5	6	67	67	67

## EQUALIZATION GRANT SIMULATIONS

The resulting per capita total revenues under each model and for actual 1999 are presented in Table VII-4. Model A2 increases median revenues per capita, except for the towns and municipalities in the county with the highest revenues per capita under actual 1999 distribution. Model B2 lowers median revenues per capita for the communes and towns and municipalities with the highest revenues and increases revenues per capita for the communes and towns and municipalities with the lowest revenues.

**Table VII-4**  
**Median Total Per Capita Revenues (1000 lei), Summary Table by County and by Type of Local Government**

	(N)	Actual 1999	Model A2	Model B2
<i>Communes</i>	291	207	269	204
County 1	49	279	353	278
County 2	52	260	341	269
County 3	39	217	259	216
County 4	82	185	234	195
County 5	69	117	219	148
<i>Towns and Municipalities</i>	34	490	552	434
County 1	3	398	449	415
County 2	13	584	726	492
County 3	5	497	549	319
County 4	7	706	625	678
County 5	6	194	207	315

Models A2 and B2 improve upon the actual distribution of 1999 transfers in terms of our two measures of equity. Table VII-5 presents the share of jurisdictions that are

“losers” under actual distribution of transfers in 1999 and under the two models. The share of local governments that were “losers” was 69 percent under the actual distribution, 43 percent under Model A2, and 60 percent under Model B2.

Model B2 uses one standard for equalization grant eligibility for small and large communes alike. Another standard is used for small and large towns and municipalities alike. Because there are economies of scale in providing services, this disfavors small local councils of each type, but in particular the smallest communes with fewer than 1000 inhabitants. Under Model B2, 57 percent of the municipalities with population under 100,000 inhabitants, 74 percent of the towns and municipalities with population under 20,000 inhabitants, and 87 percent of the communes with population under 2,000 inhabitants are “losers.”<sup>20</sup> There are different options for addressing this situation. One would be to create an indicator of fiscal capacity based on revenues per capita for each local government type *and* population category. This would take into account differences in economies of scale.

**Table VII-5**  
**Share of Local Councils with 1999 Transfers Less Than Half Their 1998 Transfers (in Real Terms)**  
**by County and by Type of Local Government**

	(N)	Actual 1999 (%)	Model A2 (%)	Model B2 (%)
<i>Total</i>	325	69	43	60
<i>Communes</i>	291	70	43	60
County 1	49	80	55	86
County 2	52	50	31	58
County 3	39	41	23	21
County 4	82	68	46	46
County 5	69	97	49	81
<i>Towns and Municipalities</i>	34	56	47	59
County 1	3	67	67	67
County 2	13	46	31	54
County 3	5	60	40	60
County 4	7	29	29	57
County 5	6	100	100	67

Table VII-6 presents the share of jurisdictions that have total revenues per capita less than half the median for each type of local government. The share of local governments which had per capita revenues less than half the median was 15 percent

<sup>20</sup> This also explains why the median per capita revenues are lower under Model B2. In calculating the median, each local council receives the same weight, regardless of its population size.





under the actual distribution, 10 percent under Model A2, and 0 percent under Model B2. The results for Model A2 are slightly better than Model A1, even though Model A2 excludes many local councils from receiving equalization grants. This is because the excluded local councils had sufficient other resources. Model B2 does not allow any local council to fall so far below the median. Even though recipient local councils should have received even more under ideal conditions, the same pool of funds as in Actual 1999 was sufficient to reduce disparity considerably when appropriate changes were made to both the revenue sharing and equalization grant distribution methods.

**Table VII-6**  
**Share of Local Councils with Per Capita Revenues 50 Percent Below Median, Summary Table by County and by Type of Local Government**

	(N)	Actual 1999 (%)	Model A2 (%)	Model B2 (%)
<i>Total</i>	325	15	10	0
<i>Communes</i>	291	13	9	0
County 1	49	0	0	0
County 2	52	4	4	0
County 3	39	0	0	0
County 4	82	13	15	0
County 5	69	38	16	0
<i>Towns and Municipalities</i>	34	26	24	0
County 1	3	0	0	0
County 2	13	23	15	0
County 3	5	40	40	0
County 4	7	0	0	0
County 5	6	67	67	0